1 UNITED STATES FEDERAL TRADE COMMISSION
2 and
3 UNITED STATES DEPARTMENT OF JUSTICE
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7 SHERMAN ACT SECTION 2 JOINT HEARING
8 UNDERSTANDING SINGLE-FIRM BEHAVIOR:
9 LOYALTY DISCOUNTS SESSION
10 WEDNESDAY, NOVEMBER 29, 2006
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15 HELD AT:
16 UNITED STATES FEDERAL TRADE COMMISSION
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23
24 Reported and transcribed by:
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12 Morning Session:

13 Joseph Kattan

14 Thomas Lambert

15 Barry Nalebuff

16 David Sibley

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18 Afternoon Session:

19 Daniel A. Crane

20 Timothy J. Muris

21 Janusz Ordover

22 Willard K. Tom

23

24

25

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1 P R O C E E D I N G S

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3 MR. DEGRABA: Good morning, and welcome to our
4 first panel of the day on loyalty discounts which is
5 part of an ongoing series of public hearings on
6 single-firm conduct jointly sponsored by the Department
7 of Justice Antitrust Division and the Federal Trade
8 Commission.
9 This series is designed to help advance the
10 development of the law concerning treatment of
11 unilateral conduct under the antitrust laws.
12 My name is Patrick DeGraba. I'm an economist
13 here at the Federal Trade Commission Bureau of
14 Economics, and I'm one of the moderators for this
15 morning's session.
16 My co-moderator is David Meyer, Deputy Assistant
17 Attorney General of the U.S. Department of Justice.
18 Before we start, I need to do a few housekeeping
19 matters.
20 As a courtesy to the speakers, please turn off
21 your cell phones, Blackberries and all other devices
22 that will beep during the proceedings. Mine's off.
23 Second, the restrooms are across the hall to the
24 left of the guard desk where you came in. So ask a
25 guard because that description won't help you get there.

1 The third is in the unlikely event that the
2 building's alarm goes off, please proceed calmly and
3 quickly as instructed. If we must leave the building,
4 exit through the main entrance. After leaving the
5 building, please follow the stream of FTC people that
6 are going to the staging area. They have practiced a
7 number of times and some of them know where they are
8 going.
9 Also, we request that you not make comments or
10 ask questions during the session. It is a moderated
11 hearing. For the speakers, I'm going to ask you to
12 please speak into the microphones. The sessions are
13 being transcribed and videotaped and the microphones are
14 the means by which the sound is captured.
15 The transcripts and other materials from the
16 session will be available on the DOJ and the FTC Web
17 sites. And finally, our next hearing will be next
18 Wednesday, December 6th, on misleading and deceptive
19 conduct.
20 Today's session, loyalty discounts include a
21 host of related contracting practices. The simplest,
22 often referred to as single-product loyalty discounts,
23 involve the seller providing a discount on all units of
24 a good sold to a buyer once that buyer has reached some
25 purchasing threshold.

1 More complicated practices, often called
2 bundling loyalty discounts, involve the seller offering
3 discounts or rebates when a buyer has reached a
4 purchasing threshold on several possibly unrelated
5 goods.
6 Such practices have raised antitrust concerns
7 recently, and the appropriate antitrust treatment of
8 such practices is clearly in a state of flux. We are
9 honored to have this morning a distinguished panel of
10 academists, economists, and private practitioners who
11 will discuss the current thinking regarding the
12 treatment of these loyalty discounts.
13 Our panelists this morning will include Barry
14 Nalebuff, a professor of economics and management at the
15 Yale University; Tom Lambert, an associate professor at
16 the University of Missouri Columbia School of Law; David
17 Sibley, a professor of economics at the University of
18 Texas at Austin; and Joe Kattan, a partner in Gibson,
19 Dunn & Crutcher, LLP in Washington, D.C.
20 The organization of the panel is as follows.
21 The four panelists will give presentations of
22 approximately 15 to 20 minutes. It will be timed by our
23 staff here in the front row.
24 We will then take a short break. And after we
25 reconvene, the panelists will have a couple minutes to

1 respond to each other's presentations, and then there
2 will be a moderated discussion. We will end about noon.
3 David, do you have any comments?
4 MR. MEYER: Not at this point.
5 MR. DEGRABA: All right. Let's get on with it.
6 Our first speaker today is Barry Nalebuff, who
7 is the Milton Steinbach professor of economics and
8 management at the Yale School of Management.
9 Professor Nalebuff has written extensively on
10 applications of game theory to business strategy and has
11 coauthored the first popular book on game theory, which
12 is used in colleges and business schools throughout the
13 world.
14 His current academic research focuses on
15 bundling and tying. He has provided expert testimony
16 and seminars on antitrust matters to federal
17 administrative agencies and courts in Australia and
18 Europe and has extensive experience consulting with
19 multinational firms.
20 Barry.
21 PROFESSOR NALEBUFF: Thanks. I'm going to be up
22 there and control it?
23 Greetings, good morning. What I'm going to try
24 and do is give you my overall perspective in terms of
25 the way I think about loyalty discounts and bundling.

1 And I'm of the view to start with that unlike
2 physics, where one is searching for a brand unification
3 theory, you won't find that here.
4 I still believe there is nothing so practical as
5 a good theory. In this case it will be multiple
6 theories. The reason is that it is different horses for
7 different courses.
8 What matters is the nature of the competition.
9 You care about whether the products in the bundle are
10 substitutes with each other, as would be the case of
11 branded and generic tape; where they are complements,
12 such as aircraft engines and avionics; where they are
13 used in some fixed proportions, like in a nail cartridge
14 and a nail; whether or not one is essential to the
15 other, such as Windows and a media player.
16 Sometimes the goods are neither complements nor
17 substitutes, in the sense of Aspen skiing. Before you
18 go to Aspen, the different mountains are complements.
19 Once you are there, they are substitutes.
20 Sometimes there is no connection, substitutes or
21 complements between them. For example, different blood
22 tests are all essential but it is not that you use them
23 together.
24 The goods that are in the bundle might be
25 positively correlated, negatively correlated or not

1 correlated at all.

2 All of these factors end up changing the
3 motivations and the effects of bundling and you have to
4 consider that when you are trying to understand the
5 effects and what to do about it.

6 The good news is that we are not in the desert
7 here lost, that in fact in each case where when you
8 understand where you are, we have the tools to analyze
9 it.

10 In my speed attempt to do 10 propositions in 10
11 minutes, here we will go. I want you to know these are
12 not bundled. You are free to accept any one of these
13 individually. But there is a discount if you take more
14 than three.

15 The first point is that often bundled discounts
16 or loyalty discounts lead to negative prices. The
17 reason for that is the discount often goes back to the
18 first unit that you buy. The end result of that is very
19 peculiar prices, things that are hard to justify.

20 This issue arises both with single and
21 multiproduct rebates. Below, this is an example that is
22 an amalgam of actual prices that I have seen from
23 different cases where things have been normalized and
24 discussed.

25 But the way it works is your price for the first

1 31 units was 100. Your price for the 32nd unit was
2 minus 6000. Your price for the next couple units is 100
3 again. When you get to the 95th unit, your price is
4 about minus 800. And then for units 96 through 100, it
5 is 97.
6 Now, if you thought about that as sort of a
7 rational way of doing it, you would say what is going on
8 here, does that really make any sense?
9 Of course the customer should never be in a
10 position of buying fewer than 31 items because in fact
11 the first 32 are free. But then having bought 32, now
12 they are okay until they get to 85 because once you get
13 to 85, 85 through 95 is free.
14 What that means is if a rival wants to come in
15 and displace the firm entirely, it will not happen
16 because 31 units are free. Moreover, a rival will never
17 be able to sell between 85 and 95 or, in that case,
18 between 5 and 15.
19 The solution, in my view, to that is to still
20 give out discounts but to give out discounts on
21 incremental volume rather than go back to square 1.
22 And note, if that's your objective to give
23 people low prices, we have ways of doing that. I'm not
24 preventing the discounts, just trying to make them a way
25 that actually makes some sense.

1 The second point is that loyalty discounts can
2 actually create no cost predation. And I'm going to
3 give you a quick example of this in terms of numbers.
4 The reason is that what we do is we inflate the
5 price of A rather than really give a discount. Imagine
6 the normal monopoly price of A is 100 and you can get it
7 at the normal monopoly price if you also buy B at 20.
8 But if you don't buy the B, then I will raise
9 the price of A to 120. Hence, the effective price of B
10 is zero or certainly below cost in this case.
11 Now, the key observation is that nobody actually
12 pays the 120 because nobody is foolish enough to only
13 buy A on an a la carte basis. Therefore, since the
14 threat is credible, it doesn't have to be used and it is
15 not costly.
16 The difference between predation and this type
17 of loyalty discount is that under predation, the firm
18 actually charges below cost, and so customers benefit
19 from those low prices.
20 Here all that is happening is the firm is
21 threatening to charge a high price if you don't go
22 along. It is like the mugger who says "your money or
23 your life," and when you give him your wallet, he wants
24 credit for actually saving your life. Actually, I don't
25 think that gets to count.

1 Because there is no need for recoupment, it is
2 easier to implement this. Hence, there is a greater
3 danger of it. Because customers aren't necessarily
4 winning along the way, there is also more reason to be
5 suspicious.
6 To give you another disguised example of this,
7 the following is a case where an incumbent firm had a
8 market power in three goods, 1, 2 and 3, and they
9 offered prices like you see in column 1.
10 However, if you were to buy all four of their
11 products, including their competitive fourth product,
12 then you would get the discount, 16, 26, 51, so on
13 percent.
14 If you added up those discounts, what you
15 discover is that the cost of buying all of the three
16 products on an a la carte basis, which essentially you
17 had to do anyway because they were the only supplier of
18 those three products, ended up being sufficiently high
19 that you were going to save $1-1/2 million by buying the
20 bundle.
21 The end result of that was it was actually a
22 negative incremental price to go and take the
23 competitive product.
24 Once again, that is something that is very hard
25 to compete with. That leads to the following proposed

1 test, which is if you have a firm which has market power
2 in A and you are worried about whether or not it is
3 going to extend that to another good, B, look at the
4 price of the A-B bundle versus the price of A alone and
5 ask how much more is the firm charging for A and ask
6 could that firm itself make money selling A at that
7 incremental price or B at that incremental price.
8 So instead of asking whether or not the rival
9 can make money selling B at that price, is the firm
10 itself apparently making incremental profits or not. If
11 it isn't, then what we have is a case of exclusion, and
12 that exclusion can be achieved without cost.
13 One of the things that is nice about this test
14 is that we actually don't have to look at actual rivals
15 or hypothetical rivals, we can look at the incumbent
16 firm's own cost structure. The incumbent firm which
17 knows its own cost structure.
18 Therefore, it is well equipped to discover
19 whether it is passing this test or not. It knows
20 whether it is in the safe harbor or it isn't.
21 There is an extra element to this test that
22 David Sibley and his co-authors have emphasized, which
23 is did the price of A go up or did the price of A-B, the
24 bundle, go down.
25 We should be more worried about the case when A

1 alone goes up than when the A-B bundle goes down
2 because, of course, when it is a threat, there is no
3 benefit. Whereas, if the bundle has been discounted, at
4 least customers are getting some value along the way.
5 One point that I think the courts have really
6 missed about loyalty discounts is that some of the ways
7 that these rebates are paid end up being significantly
8 less competitive than a straight price cut.
9 So, again, think of a case where the incumbent
10 has market power in A, and B is a substitute. And the
11 two examples I will take you through are Scotch tape and
12 generic tape or Keflin and Kefzol, two cephalosporins,
13 where Keflin was the big money maker and Kefzol was the
14 new product which is the competitive one.
15 In the cephalosporin market, we had Lily with
16 its monopoly and Keflin, Keflex, Loradine, Kaphacen and
17 facing competition with SmithKline Ancef, which was the
18 exact same compound as Kefzol.
19 The first thing they tried doing was just
20 discounting Kefzol to match the prices on Ancef. The
21 problem with that was that Kefzol ended up being a
22 substitute for Keflin.
23 So not only did they have trouble capturing the
24 market against Ancef, as prices starting getting lower,
25 it started eating in on the demand to Keflin.

1 Then they got wise and said okay, we will give
2 you a rebate on Keflin and the other products if you buy
3 enough of our goods.
4 Now, note what happens here. The price of
5 Kefzol ends up being high. I'm getting a million
6 dollars back or some fixed amount of money back, but I
7 don't end up discounting Kefzol.
8 In essence, I'm bribing you to say if you buy
9 all of my goods, I will give you this fixed amount of
10 money. But because Kefzol keeps its price high, that
11 reduces the competition between Kefzol and Keflin, and,
12 hence, customers don't get that benefit.
13 We also see that by its equivalent it is almost
14 as if Lily says to the customer we will give you 100
15 units of Kefzol for free on the condition that that's
16 all you use, which of course is something again that
17 rivals would have a hard time matching.
18 We have the same issue in LePage's. If you are
19 3M, you don't want to get into a price war with LePage's
20 over generic tape, because the cheaper generic tape
21 gets, the more that will eat into Scotch tape prices.
22 What you want to do is how can I beat LePage's
23 without discounting my generic tape. Well, if I give
24 them a bribe, a million dollars just to take my goods,
25 even if they are high priced and you can spread out that

1 million dollars over their expected sales, then you can
2 say the overall deal is better for me, Staples, than it
3 is for taking LePage's.
4 But note the incremental cost of another roll of
5 tape is high. What that means is the price to consumers
6 for that tape is going to be high and there will be less
7 substitution of generic for branded product.
8 So in that sense, these rebates don't get passed
9 on to consumers and don't threaten the incumbent
10 monopoly.
11 That's an aspect of these loyalty rebates that I
12 don't think has been appreciated and I think is
13 problematic.
14 Another area is that loyalty rebates make
15 pricing incredibly hard to understand. If somebody
16 offers 2.93, I know that is cheaper than 2.97. But if
17 somebody says you get 3 percent off A and B if you buy
18 B, is that a good deal or not? Well, it depends on how
19 much A I'm going to buy. And sometimes I know the
20 answer to that and sometimes I don't.
21 Moreover, if rivals are trying to compete and
22 think about how much they have to undercut to get the
23 business, that means the B rival has to forecast my
24 demand for A, and, generally speaking, they are not very
25 well equipped to do that.

1 So we have seen cases where people misforecast
2 these demands, end up buying the wrong product or don't
3 get discounts as large as they think.
4 I have also found that actually analyzing these
5 price things can often take an MBA. And it is not an
6 understatement to say it costs $10,000 to actually
7 figure out what price is the cheapest, and many times
8 that is not worth it for the individual customer to do.
9 An issue that bothers me about loyalty discounts
10 is that the price a firm charges to a customer shouldn't
11 depend on who else the customer buys from. I have less
12 a problem if the price says if you buy many units,
13 here's the charges. If you buy this many more units
14 this year compared to last year, here's the charge.
15 I think it is very funny to say to the customer,
16 "oh, and if you buy 10 units from Fred, I'm going to
17 charge you more money" or "if you buy 3 percent of your
18 products from Fred, I'm going to charge you more money."
19 The price that I charge you should ultimately
20 depend only on what it is that you buy from me, not what
21 it is that you buy from other people.
22 Now, I realize that the effect may be the same
23 through some volume discounts. But that still leaves
24 many more options in an uncertain environment for a
25 rival to come in than when you literally price based on

1 what you are doing with your rivals.
2 You will hear many what I will flat out call
3 bogus justifications for bundled discounts. For
4 example, it is often said that customers like bundles
5 and, hence, that's a justification for doing bundling.
6 Yes, that's true, but it is not a justification
7 for a bundle discount. Because a customer likes it, in
8 theory you could charge more for it. You don't have to
9 offer it as a discount if you are providing something
10 customers like better.
11 We do the discount for price discrimination.
12 Well, there is no room for price discrimination if A and
13 B are consumed in fixed proportions.
14 Moreover, the arguments for price discrimination
15 generally rely on having a negative correlation between
16 the two products or no correlation in valuation between
17 the two products.
18 For example, opera tickets and wrestling tickets
19 you think of as having negative correlation. However,
20 if you look at what's bundled out there, I think you
21 will find that they generally have a positive
22 correlation in value and, hence, don't fit the normal
23 framework that we would expect price discrimination to
24 fall under.
25 Yes, Virginia, bundling can leverage and protect

1 market power. Here is an example of how that works.
2 If we have a monopolist whose demand is
3 represented by 10 minus P and the cost is zero, the
4 monopoly price would be 5. Profits would be 5 times 5.
5 Price is 5, quantity is 5.
6 I'm having the B product be competitive with a
7 cost of one. So the price is one. Demand I'm making
8 just to be one unit.
9 Chicago School says don't sell A and B together
10 at 6. I do better just to sell A alone at 5, because
11 there are some people who may not want B, even at the
12 competitive price.
13 What I say is consider the following contract.
14 If you buy my B, I will lower the price of A to 4. But
15 if you don't buy my B, I will raise the price of A to 6.
16 Well, if you think about the cost of that threat
17 and promise, the customer is going to save at least $2
18 on A by buying the B product since they are going to be
19 buying at least four units of A.
20 That means that it is a net savings to them of
21 at least 8, which means they are willing to pay up to 9
22 in order to get that discount. They will pay 9 on B to
23 get that discount.
24 Well, the discount doesn't cost the firm very
25 much. And the reason is that discounts my price from 5

1 to 4 only lowers my profits from 25 to 24. Raising my
2 price from 5 to 6 also only lowers my profits from 25 to
3 24.
4 So at a cost to me of only a dollar here, I can
5 do something that will either reward or punish the
6 customer to the tune of 8. And the reason for this is
7 the monopoly is inefficient.
8 So in essence, what I'm saying to the customer
9 is I'm willing to be a less inefficient monopolist if
10 you play ball with me and do what I'm asking on good B.
11 It doesn't make sense to take out all of your monopoly
12 rents on the monopoly product because that's what leads
13 to dead weight losses.
14 What I would like to do is some type of lump sum
15 payment and incremental pricing and charge the customer
16 for the right to buy my goods at a reasonable price.
17 Oftentimes the way we see that happen is the way
18 I charge them for being less of a monopolist is I say
19 you have to buy my other goods at B at inflated prices.
20 It is also the case that the bundle allows firms
21 with multiple market powers to protect themselves. So
22 if I have market power in A and B and charge 10 for A
23 and 10 for B but only 16 for the two together, there is
24 a $4 discount that any single-firm rival would have to
25 meet in order to undercut me.

1 Note that my average price is 8. In essence, I
2 get to use that same $4 discount on multiple fronts. So
3 the customer isn't benefitting $4. The customer is only
4 benefitting 2 on each.
5 Rivals would actually have to go 4 below. That
6 is a special sauce in multigood bundling that makes the
7 incumbent have an advantage over rivals. It is sort of
8 why it works.
9 It also explains to me why the right test should
10 not be whether or not the overall bundle is above or
11 below cost but whether or not the individual components
12 at the appropriate incremental price is above or below
13 cost.
14 So the Chicago School story is correct in its
15 limited environment, but it misses most of the
16 interesting cases that we look at when it comes to
17 bundling.
18 Even where there is one monopoly profit, that
19 monopoly profit can be of different sizes. In
20 particular, bundling can allow price discrimination,
21 such as through metering and some of the examples you
22 have seen, which, therefore, leads to greater profits to
23 the monopolist but less surplus to the consumer.
24 It is also the case that many of the motivations
25 for bundling are dynamic, that by preventing somebody

1 from getting into the B market, that may be their
2 subsequent entry into the A market which is where I
3 still have market power.
4 It is also the case that bundling and tying
5 provide potential for no cost for closure, which has the
6 same effect as predatory pricing but at no cost.
7 I recognize that bundles versus bundles is
8 generally more competitive than individual items versus
9 each other. So what I would like to be able to do is
10 take the advantage of that competition without the harm.
11 And the way that I do that is the following. I
12 actually take the example from Johnson & Johnson who
13 said, look, U.S. Surgical, you have a full line, we have
14 a full line, Coke and Pepsi, you each have full lines,
15 you can compete against me bundle for bundle.
16 But if I don't have a full line, I will not
17 count your sales in my 80 percent number or 90 percent
18 number. Whatever target I make, it is only a target for
19 other full-line competitors.
20 We have come our way through the deserts often
21 through intuition. There are now some tests that I hope
22 you will believe offer more formal approaches.
23 And I believe -- maybe this is a temptation here
24 -- that the theories of bundling loyalty discounts are
25 now ready for prime time. So I hope you will be able to

1 use them.
2 Thank you.
3 (Applause.)
4 MR. DEGRABA: Thank you.
5 Our next speaker is Tom Lambert, who is an
6 associate professor at the University of Missouri
7 Columbia School of Law, where he has achieved the
8 university's Gold Chalk Award for excellence in graduate
9 teaching.
10 Professor Lambert's scholarship focuses on
11 regulatory theory, including antitrust policy and
12 business law. His 2005 Minnesota Law Review article
13 provided one of the first scholarly treatments of the
14 law of bundling discounts.
15 Tom is a member of the eSapience Center for
16 Competition Policy and is a regular contributor to Truth
17 on the Market, a Weblog devoted to academic commentary
18 on law, business, economics and more.
19 Tom.
20 PROFESSOR LAMBERT: Thank you.
21 It is an honor to be here on such a
22 distinguished panel. I will talk today about bundled
23 discounts entirely. I will not focus on single product
24 loyalty discounts.
25 A word about the scope of my remarks. I'm a

1 lawyer, not an economist. I'm very concerned with
2 structuring rules in a way that they can be administered
3 by judges and juries and used by antitrust counselors to
4 advice their clients.
5 My focus is on the law, how we would structure
6 the rules.
7 I have a three-pronged agenda that's very
8 ambitious for 20 minutes.
9 Why are bundled discounts troubling, and I will
10 give you the straightforward view the courts have
11 adopted and most of you are familiar with this.
12 Summarizing and critiquing of the leading
13 evaluative approaches offers an alternative proposal
14 that I think is very administrable.
15 The problem with bundled discounts the courts
16 have recognized is they may lead to the exclusion of an
17 equally efficient but less diversified rival even if
18 they are above cost.
19 The classic example of this came in the Ortho
20 Diagnostic case. It is I think a little bit
21 unrealistic, but this is what the court wrote in its
22 opinion and it illustrates the problem, I think.
23 You can have two manufacturers who sell the same
24 product, manufacturer A and manufacturer B. They both
25 make shampoo. Manufacturer B is the more efficient

1 producer. It can produce shampoo at $1.25 a bottle.
2 Manufacturer A, it costs $1.50 to produce the shampoo.
3 Manufacturer A, though, is a more diversified
4 rival. It sells conditioner as well as shampoo.
5 So by bundling its shampoo and conditioner and
6 by offering an above-cost bundled discount -- and what I
7 mean there is that the price, the discounted price of
8 the bundle is in excess of manufacturer A's cost of
9 producing the bundle -- manufacturer A can effectively
10 exclude manufacturer B from the market.
11 If the separate price of shampoo and conditioner
12 for A is $2 and $4, so that buying them separately you
13 would have to pay $6, and manufacturer A charges a
14 package price of $5, that is still a dollar in excess of
15 its average variable cost of four dollars. Manufacturer
16 B can't compete with that.
17 In order to sell its shampoo -- and any buyer
18 that buys both shampoo and conditioner will have to pay
19 $4 for the conditioner and will not be willing to pay
20 any more than $1 for the shampoo. Manufacturer B is
21 excluded despite the fact that it is the more efficient
22 producer.
23 So the fundamental problem the courts have
24 identified is that bundled discounts can lead to the
25 sort of exclusion of equally efficient but less

1 diversified rivals, and that's the case even if the
2 discount is above cost.
3 All right. I have identified six approaches in
4 the case law and commentary for evaluating the legality
5 of bundled discounts. I want to march through them
6 quickly and explain why I think each is a little bit
7 troubling.
8 The first and the most sort of laissez-faire is
9 a rule of per se legality. This is the rule that's been
10 advocated most recently by Professor Hovenkamp in his
11 new book, "The Antitrust Enterprise," and also the rule
12 advocated by Demicci in the LePage's case.
13 It basically says a bundled discount should be
14 per se legal if the discounted price of the bundle
15 exceeds the aggregate cost of the products within the
16 bundle.
17 The reason for this rule is not that we don't
18 believe that above-cost bundled discounts can ever be
19 anticompetitive. The Ortho Diagnostic example showed
20 how they could lead to the exclusion of a more efficient
21 rival.
22 Administrability concerns motivate this rule.
23 The idea is that it is simply too difficult to separate
24 the pro-competitive wheat from the anticompetitive chaff
25 and will end up chilling pro-competitive bundled

1 discounting if we don't have the sort of safe harbor,
2 and so the best approach is to have a per se legality
3 rule for above-cost bundled discounts, very much along
4 the lines of the Brook Group rule.
5 My criticism is -- well, I'm not all that
6 critical. In the long run, this may be the best
7 approach to take. However, I'm not willing to concede
8 that at this point.
9 I think the search for anticompetitive bundled
10 discounts may be worth the cost, including the cost of
11 deterring some pro-competitive bundled discounts.
12 It is very easy to imagine instances of
13 anticompetitive exclusion. Professor Nalebuff and
14 Professor Sibley have modeled cases where this could
15 occur. The Ortho Diagnostic example is a good example.
16 I think there is a fairly easily administrable
17 weeding device that can help us separate pro-competitive
18 from anticompetitive bundled discounts. I will get to
19 that in just a minute.
20 The second approach is at the other end of the
21 spectrum -- and this is an approach from the raising
22 rivals costs literature. I'm thinking in particular of
23 Will Tom, who will speak this afternoon, and Einer
24 Elhauge, who has discussed this in testimony on hospital
25 group purchasing organizations and also in his Stanford

1 Law Review article defining better monopolization
2 standards.
3 This approach says that bundled discounts are
4 discounts are illegal if they unjustifiably usurp so
5 much business from their rivals that their rival's costs
6 are erased.
7 Now, the $64,000 question here is how do you
8 determine what is unjustifiable. Every discount tends
9 to usurp some business from rivals. And obviously we
10 don't want to ban discounts.
11 The concern here is that so much business will
12 be usurped from rivals that it will deny rivals
13 economies of scale, make it harder for them to raise
14 capital.
15 A couple of approaches have been advocated for
16 identifying what are unjustifiable instances of raising
17 rival's cost.
18 Will Tom suggests in his article on the
19 Antitrust Law Journal that we adopt a case-by-case test
20 where the courts look to see is this an exclusionary
21 usurpation of the business or a pro-competitive
22 usurpation of the business.
23 That is difficult because that leaves a lot open
24 to the whims of juries and judges and will likely have a
25 chilling effect on pro-competitive bundled discounts.

1 Professor Elhauge has suggested an approach
2 where a business-usurping discount is justified only if
3 the discounter's business stealing, business usurpation
4 occurs because the bundling has made the discounter more
5 efficient.
6 If you are stealing business because your
7 bundling is making you more efficient, then that's okay.
8 But if you are stealing business for any other reason,
9 then that's illegal.
10 I think this is a troubling approach for several
11 reasons. First, it would prevent price cutting by a
12 monopolist who has reached minimum efficient scale and
13 can't achieve any additional distribution efficiencies
14 by bundling.
15 That person is not getting any efficiency
16 benefits from the bundling and then would be precluded
17 from cutting prices, which seems bad for consumers.
18 Secondly, this approach is very difficult to
19 administer. A court would have to figure out what is
20 minimum efficient scale, very difficult for judges and
21 juries to do.
22 In addition, it has to figure out what discount,
23 what amount of discount is necessary to get the
24 discounter to the point of minimum efficient scale. Any
25 discount beyond that would be excessive discount and

1 under Professor Elhauge's test would be exclusionary.
2 That is extremely difficult for judges and
3 juries to administer. For that reason, this approach is
4 likely to have a major chilling effect. Discounters
5 discount at their own peril.
6 The third approach is the approach we sort of
7 see in LePage's. Everyone in this room knows it is very
8 difficult to articulate a rule of law from the LePage's
9 case.
10 There were some key facts that were very
11 important in the court's analysis there. LePage's was
12 not required to prove that it couldn't match the 3M
13 discount. It was not required to prove it was as
14 efficient a manufacturer as 3M was.
15 Instead, it just had to show that it was being
16 excluded. And once it showed that, the burden shifted
17 to 3M to justify its behavior.
18 So if you want to take away a rule from that --
19 and lots of smart antitrust counselors are trying to do
20 so and advise their clients accordingly -- it would seem
21 to be the following. A bundled discount is
22 presumptively exclusionary if the discounter is bundling
23 products not sold by rivals and is winning business from
24 those rivals.
25 Now, the discounter may rebut that presumption

1 if it proves a business reasons justification. There is
2 a suggestion in the LePage's case that that
3 justification must show that the bundling saves costs
4 approaching the amount of the discount, very similar to
5 Professor Elhauge's suggestion in the Stanford Law
6 Review.
7 This I believe is a very troubling rule. First
8 of all, since the plaintiff need not establish its
9 equivalent efficiency, this approach essentially creates
10 a price umbrella for less efficient rivals.
11 And there is a suggestion in LePage's that's
12 exactly what happened. LePage's expert economist
13 conceded that LePage's was a less efficient manufacturer
14 of tape than 3M and yet LePage's won.
15 Moreover, since the focus is on product line
16 breadth and not whether an efficient rival is being
17 excluded, this approach will tend to chill bundling,
18 which has a number of pro-competitive benefits which we
19 will talk about in the roundtable discussion. I assume
20 that some of my co-panelists will discuss that issue.
21 The third approach here -- fourth approach, I
22 guess -- the approach we see in the Ortho Diagnostic
23 decision, in that case, the court reasoned that a
24 bundled discount is illegal if the plaintiff shows
25 either that the bundle is priced below average variable

1 cost, straightforward predatory pricing, or that the
2 plaintiff is at least as efficient a producer of the
3 competitive product but cannot match the discount
4 without pricing below cost on that product.
5 In other words, you have to show you are an
6 equally efficient rival, and after you show you are an
7 equally efficient rival, you show if you attribute the
8 full amount of the discount to the competitive product,
9 that will result in below-cost pricing by the
10 discounter. You couldn't match that discount.
11 My criticism of this rule, it is a great rule in
12 theory, but this is a very difficult rule to administer.
13 The plaintiff, in order to prevail, has to show
14 that it is an equally efficient rival. To do that, it
15 has to establish its own cost and the discounter's cost.
16 In addition, there are going to be joint costs
17 in here because this is a bundling case. In figuring
18 out the discounter's cost on its competitive product, it
19 has to figure out what percentage of the joint cost it
20 should attribute to that competitive product.
21 That is an incredibly difficult rule to
22 administer. For that reason, I believe this rule, the
23 rule of law in Ortho Diagnostic, may be underdeterrent,
24 because plaintiffs are going to have a hard time winning
25 these cases.

1 The next approach is what I'm calling the
2 original antitrust law approach. This is the approach
3 that was advocated in the Areta/Hovenkamp treatise. It
4 was updated this summer. I had to update my
5 presentation.
6 The original approach advocated by the treatise
7 was focused on trying to fix the administrability
8 problems with the Ortho Diagnostic test.
9 Rather than asking if the plaintiff itself was
10 an equally efficient rival, the original antitrust law
11 approach said let's ask if a hypothetical equally
12 efficient single-product rival would be excluded by this
13 discount and without adequate business justification.
14 So essentially we take the Ortho Diagnostic
15 test, we lop off the part where the plaintiff has to
16 show that it is actually an equally efficient rival, and
17 we say if you attributed the entire amount of the
18 bundled discount to the competitive product, would a
19 hypothetical single product be excluded by this
20 discount.
21 This is definitely an easier to administer test
22 because plaintiffs don't have to prove the defendant's
23 costs where there are joint costs. It is troubling,
24 though, for a couple reasons.
25 First, it prevents discount cross-subsidization.

1 Consider a situation where you have a seller that sells
2 products A, B and C. Its cost is $4 each. It sells
3 them separately for $5 each. But it would sell the
4 bundle for $13.50.
5 Under the antitrust law approach, this would be
6 a presumptively exclusionary discount because a single
7 product seller of A that was equally efficient at a cost
8 of $4 couldn't match this discount because it would have
9 to charge a price of $3.50, a price below its cost.
10 Now, if you think about an oligopolistic
11 market -- it is not cartelized, but there is a lot of
12 what looks to be tacit collusion -- if you assume the
13 seller that sells A, B and C is selling in that market,
14 it is great that the seller can engage in the sort of
15 complicated pricing.
16 Professor Nalebuff says it is very difficult to
17 figure out exactly what price is being charged.
18 That's a fantastic thing in an oligopolistic
19 market. This sort of pricing can disrupt, this sort of
20 bundling can disrupt oligopolistic pricing. In
21 addition, it is a discount for customers. That would
22 seem to be good in itself.
23 A second problem with the antitrust law approach
24 is there was no requirement that the foreclosed market
25 be capable of monopolization, there was no requirement

1 that there be entry barriers in the foreclosed market
2 that the plaintiff was being excluded from.
3 The revised antitrust law approach is definitely
4 superior to the original. But I still think it is a
5 little bit troubling.
6 What Professor Hovenkamp is now saying -- which,
7 by the way, seems to conflict with his book, "The
8 Antitrust Enterprise" -- is that we should analogize
9 bundled discounts to tying and say there is a tie-in if
10 the price is below cost when the entire discount is
11 attributed to the competitive product.
12 Very importantly, the treatise points out there
13 will not be this tie-in if there is another significant
14 rival that sells all products. In the Johnson & Johnson
15 versus Tyco case or U.S. Surgical case,
16 Johnson & Johnson engaged in this bundling, but there
17 was another significant rival that had the same bundle
18 in place.
19 Professor Hovenkamp would say that does not
20 constitute a tie. But absent such a significant rival,
21 there would be a tie-in if there was a below-cost price
22 after the discount was attributed to the competitive
23 product.
24 The treatise then says that after you find time,
25 you should apply a basic rule of reasoned approach, ask

1 whether the foreclosed market is capable of
2 monopolization, ask if a collaborative bundle is
3 probable, ask if there are pro-competitive
4 justifications for the bundling.
5 This is a definite improvement on the original
6 version. My criticism is why involve tying at all. It
7 seems to me that the reason that we are concerned about
8 tying in cases like this is that it leads to
9 foreclosure.
10 Why should we focus on the tie rather than
11 focusing directly on the foreclosure issue?
12 Here is my alternative proposal. The goals of
13 the proposal is we want to condemn bundled discounts
14 that could eliminate competitive rivals and result in
15 price increases. We don't want to condemn other bundled
16 discounts. And we want the rule to be easy to
17 administer.
18 What I want to structure my rule to show is that
19 the complaining rival has exhausted its competitive
20 options. You are not a competitive rival unless you
21 have done everything you can to stay in business.
22 The complaining rival must have the ability to
23 match the bundled discounter's efficiency. You are not
24 a competitive rival if you are not as good as the
25 bundler.

1 We have to show the foreclosed market is capable
2 of monopolization. We don't want to ban discounts in
3 markets that can't be monopolized because there are very
4 low barriers to entry.
5 Here is a proposed rule. I would have a rule
6 that says that the above-cost discount, and that means
7 that if you add up the cost of all the items in the
8 bundle, they are exceeded by the price of the bundle.
9 So the above-cost discount is per se legal
10 unless the plaintiff could not match without pricing
11 below cost and, number one, barriers to entry exist in,
12 A, the product market in which the plaintiff doesn't
13 participate, and, B, the market for the competitive
14 product, a collaborative bundle is impracticable, a
15 good-faith supply offer was rejected. That means that
16 the foreclosed firm goes to the bundled discounter and
17 says, hey, let me supply my products to you, you buy my
18 product and bundle it.
19 And if those are established, then the bundle is
20 considered presumptively exclusionary, but the defendant
21 gets a rebuttal opportunity to show that it rejected
22 this good-faith supply offer because it wasn't
23 attractive, either the price being offered was too high
24 or the quality was insufficient.
25 Let me explain how this meets all of my goals of

1 protecting competitive rivals. We want to protect
2 competitive rivals and only competitive rivals, and we
3 want to ensure that the market that is being foreclosed
4 is capable of monopolization.
5 The above-cost discount is per se legal unless
6 the plaintiff could not match without pricing below
7 cost. That requires a complaining plaintiff to lower
8 its price to the level of its marginal cost.
9 That's what we expect will happen in perfect
10 competition. We should demand that of a complaining
11 rival.
12 Next, it has to show that barriers to entry
13 exist in a product market in which the plaintiff doesn't
14 participate. An option for a plaintiff that's
15 confronting a bundled discount is to enter the other
16 markets in which it doesn't participate. It needs to
17 show there are some entry barriers that prevent it from
18 being able to do so.
19 In addition, it has to show barriers to entry
20 into the market for the competitive product. That's
21 required to show the market is in fact capable of
22 monopolization.
23 Supercompetitive prices could be charged in that
24 market without inviting so much entry that it is
25 impossible to charge those prices.

1 Next, the plaintiff would have to show that a
2 collaborative bundle is impracticable. It cannot
3 compete with the bundle by entering into agreements with
4 sellers of other products to craft a competing bundle.
5 These sort of cross-seller bundles are
6 incredibly common. I sent my research assistant to
7 Target, and he found an Olympus digital voice recorded
8 bundled with batteries, Suave body wash bundled with a
9 Schick razor, Colgate White-Plus teeth whitening cream
10 bundled with a camera. Americans are vain.
11 The prima facie case here is intended to show
12 that the plaintiff has exhausted its competitive options
13 and that the market being foreclosed is capable of
14 monopolization.
15 Then we have a rebuttal opportunity. The
16 defendant may rebut by showing that the supply offer was
17 not attractive.
18 The defendant has to show that when the
19 plaintiff came and made the supply offer to me, I didn't
20 accept it because the price it was charging me was
21 higher than my cost. That shows that the plaintiff is
22 in fact a less efficient rival.
23 If the plaintiff can show its prima facie case
24 and the defendant can't rebut, then we have an exclusion
25 of a competitive rival in a market that is capable of

1 foreclosure or capable of monopolization, and it would
2 seem to me that liability is appropriate.
3 Otherwise, I would have a rule that these sorts
4 of discounts which are discounts, good to customers, are
5 legal.
6 Thanks.
7 (Applause.)
8 MR. DEGRABA: Our next speaker is David Sibley,
9 who is the John Michael Stuart Centennial professor of
10 economics at the University of Texas at Austin.
11 Professor Sibley was previously the head of the
12 economics research group at Bell Communications Research
13 and served as a member of the technical staff in
14 economics at Bell Labs.
15 In 2003 and 2004, David served as a Deputy
16 Assistant Attorney General for economic analysis in the
17 Antitrust Division.
18 Professor Sibley has carried out extensive
19 research in the area of industrial organization,
20 microeconomic theory and regulation, and his
21 publications have appeared in numerous leading economics
22 journals. He has consulted extensively for various
23 firms and agencies, both in the United States and
24 abroad, on antitrust and regulatory matters.
25 David.

1 PROFESSOR SIBLEY: Thank you.
2 The title of my talk, what have we learned since
3 LePage's about bundled discounts, I guess is sort of
4 inspired by the feeling of knowing not what to say at
5 the Antitrust Division when the parties representing
6 both sides of LePage's came to convince us either to
7 support a take cert brief or not.
8 There was not a whole lot the economists had to
9 say. Greg Warden was on the right track when he said
10 "what do the prices do?"
11 It turned out you couldn't tell from the
12 evidence in the record. I take LePage's as kind of a
13 baseline as sort of very useful knowledge.
14 What have we done since then? Well, there has
15 been some progress. We understand now I think better
16 the effects of bundled discounts on both foreclosure and
17 customer welfare.
18 I mentioned foreclosure and customer welfare
19 separately here because, as we will see, it is possible
20 to have a bundled discount which increases customer
21 welfare and yet excludes equally efficient rivals.
22 I expect that to be the case from the way
23 bundled discounts can be structured. I will also talk
24 about tests to determine if a bundled discount is
25 anticompetitive.

1 This would be in the spirit of the Ortho test
2 with its explication of extension by Barry Nalebuff or
3 tests whether customer welfare rises or falls. The
4 reference here would be what I was aware of without
5 having to go to any trouble to look up more, Wrightman,
6 Sibley and Roy Nalebuff.
7 The tests here I guess were designed originally,
8 both to try to see whether we could figure out whether
9 bundled discounts are good or bad but also with a view
10 toward the same type of goal that Tom Lambert had,
11 administrability here.
12 We wanted simple tests that didn't require you
13 to calculate complicated things or use data that you are
14 not likely to be able to get in practice. The result is
15 we have tests that will work sometimes but not all the
16 time.
17 To start, I will take a very simple set-up which
18 is actually I think probably the set-up behind some of
19 the slides here.
20 A is a monopoly market served by a firm we will
21 call Firm 1. B is a competitive market. It might not
22 be perfectly competitive. I think for the next five
23 minutes or so I will assume it is perfectly competitive.
24 But it doesn't have to be.
25 Firm 1 is a seller in the B market too. I think

1 for the purpose of the rest of the slide, I want to
2 assume a couple things, one, that the B market is
3 perfectly competitive and some B customers will buy B
4 only and some will buy A only.
5 A couple of preliminary observations. Starting
6 from independent pricing, a bundled discount or a BD can
7 raise both profits and customer welfare. That doesn't
8 mean that it will actually happen by a profit-maximizing
9 profit discounter, but it is capable of happening.
10 We should keep that in mind. The logic is
11 really as follows. Let's suppose we have a preexisting
12 time that we can observe where Firm 1 is engaged in
13 independent pricing and it is a monopolist in market A.
14 We will assume that if it hasn't anticipated the
15 onset of the regulatory rule I will be talking about,
16 that the price it charged to the A market was probably a
17 monopoly price.
18 As Barry was saying, if the monopoly price is --
19 if the price charged by firm one in the A market really
20 was the profit-maximizing monopoly price, then it is
21 always possible to have a slight discount on the price
22 of A, which will have an insignificant effect on profits
23 that Firm 1 generates in market A.
24 In Barry's example, it was a $1 increase in
25 profits. From a customer welfare standpoint, that is

1 not an insignificant increase in customer welfare.
2 That allows the firm, Firm 1, to bundle that
3 slightly lower price of A with a price of B that's above
4 marginal costs and still get A and B consumers to select
5 the bundle in preference to buying any A at all or
6 paying a bundled price for it and getting B at a
7 marginal cost.
8 In that situation, the A/B consumers are better
9 off. They can all select the bundle that will make them
10 better off.
11 B-only consumers are nowhere better and no worse
12 off than before. They are getting B at marginal cost
13 from all the other perfect competitors out there.
14 If the bundled discount in doing this has an
15 out-of-bundled price no higher than the previous
16 monopoly price under independent pricing, then we know
17 that consumers' options within the bundle are no worse
18 than before.
19 In fact, we have designed the bundle to attract
20 them away from independent pricing of A and marginal
21 cost of B. So they are better too.
22 So starting from independent pricing, which
23 would be the marginal cost of B for everyone, including
24 Firm 1, and the profit-maximizing monopoly price of A by
25 Firm 1, we can always construct a bundled discount which

1 raises customer welfare and also raises profits for Firm
2 1.
3 Now, this has an interesting effect here. There
4 is implicit in this the foreclosure result.
5 Since the A and B customers are better off
6 taking the bundle, even at a price of B that is slightly
7 above marginal cost, this means that a B-only seller,
8 one of those perfect competitors, can't appeal to these
9 folks without charging below-market costs. Equally
10 efficient providers are foreclosed and, yet, consumer
11 welfare has gone up.
12 Clearly I have contrived this example to make a
13 point. But it is a point that I suspect in practice
14 comes up often enough to make it interesting.
15 It at least points out when we are talking about
16 bundled discounts, we should not equate foreclosing
17 equally efficient firms with lowering consumer welfare.
18 In my example, consumer welfare is higher. The
19 single-line producers of B would just sell to B-only
20 consumers.
21 Okay. Another point that is implicit to what
22 Barry said which I should have mentioned a moment ago,
23 we are going to assume here that under independent
24 pricing, the Firm 1, the monopolist in the market for A,
25 has not been able to extract all consumer surplus in the

1 market for A.
2 In principle, the firm might do this by a
3 perfect two-part tariff, for example. In practice, I
4 think neither Barry nor I think this is a big deal. If
5 it were, we would see lots more two-part tariffs with a
6 lot fewer loyalty discounts than we do.
7 If consumers' demands have some uncertainty and
8 consumers know more about what their demands are, then
9 you will not have a two-part tariff anyway, and you
10 would find that would still be of some use.
11 So far we are talking again about a monopolist
12 in the market for A and everyone inside is a perfect
13 competitor in B.
14 Had I taken more time on this particular slide,
15 I would have had a third bullet point which contrasts
16 what you might expect Firm 1 to actually do with the
17 possibility of raising both consumer welfare and
18 profits.
19 In practice, you wouldn't expect the firm to be
20 interested in raising consumer welfare. So profit
21 maximizing in a very simple setting where B is perfectly
22 competitive and products are not differentiated and the
23 only thing consumers care about is price, in that
24 setting profit-maximizing behavior by Firm 1 is to raise
25 the out-of-bundled price of A a great deal.

1 The only point of the out-of-bundled price is to
2 essentially stampede consumers into buying product. In
3 fact, you would give them very bad out-of-bundle
4 alternatives, $10 trillion an ounce or whatever it might
5 be.
6 Of course, they could buy B at marginal cost
7 from competitors. This puts consumers of A and B in a
8 much worse position.
9 So in that setting, the effect of
10 profit-maximizing bundling would not be to raise
11 consumer welfare. It would be to increase profits and
12 lower consumer welfare.
13 Let's not lose sight of the fact that if the
14 out-of-bundled price of A is no higher than the
15 preexisting monopoly price of A under independent
16 pricing, we have the result which has the interesting
17 effect, as I said a moment ago, of excluding sellers in
18 B market from selling to consumers that buy A and B.
19 What I will do next is to change the story and
20 the market for B a little bit. What I talked about so
21 far I suspect people in the audience have heard before
22 from me, from what I have heard. It is on the paper on
23 SSRN for a while. My coauthors and I have labored to
24 extend the results and have had some progress.
25 The story I will tell next, suppose that the

1 market for B is not perfectly competitive. It has two
2 firms, one of which is Firm 1. They produce
3 differentiated products.
4 So yes, there are substitutes but not perfect
5 substitutes. Consumers have tastes which are some will
6 prefirm firm 2's version of B and some prefer Firm 1's
7 version. You have a distribution of tastes in the
8 market for B.
9 Some consumers want only B, but there is also a
10 population of A and B consumers. If you look at those
11 folks, the ones who want A, we will assume the same
12 distribution of taste as regard to B. So there are some
13 A/B consumers who really like Firm 1's flavor of B but
14 some who really like Firm 2's.
15 In this setting, the world changes a fair
16 amount. Let me talk you through things before I go to
17 the bullet point here.
18 Firm 1 now has a much more interesting role for
19 the out-of-bundled price of A than it had a moment ago
20 when I assumed that the B market was perfectly
21 competitive and all sellers in B produced a homogeneous
22 product.
23 In this case, Firm 1 realizes there are folks
24 out there wanting to buy my monopoly product which
25 really want to buy B from the other guy.

1 The tools at my disposal if I'm Firm 1 are I
2 will have out-of-bundled prices for A and B and bundled
3 prices for A and B.
4 I also know there are some A consumers who also
5 prefer my version of B. How hard do I want to try to
6 retain consumers that want to buy A but really want to
7 buy firm 2's version of B?
8 If I am going to keep those folks, I might have
9 to really discount the price of the bundle a lot. If I
10 do that, then I'm passing up profits that I could make
11 on A and B consumers that like my version of B.
12 So maybe I won't do it. Maybe it is better not
13 to try so hard. I will simply concede A/B consumers
14 that prefer firm 2's version of B to Firm 2.
15 Now, I still would like to make some money off
16 them. I would like them to continue to buy A from me.
17 So my out-of-bundled price for A in this
18 setting, although it is a high price, is no longer set
19 at some infinite level that is designed solely to
20 stampede people into buying the bundle. It is low
21 enough so that A/B consumers that like Firm 2's version
22 of B are still going to buy some A product.
23 So the stand-alone price of A, the out-of-bundle
24 price of A in this setting has a price discrimination
25 goal as well as incentive to buy the bundle. It is a

1 more complicated world.
2 Now, look at the first bundle here. Compared to
3 independent pricing, consumer welfare can go up or down
4 assuming that Firm 2 does not exit the B market. In
5 this bullet, when I say consumer welfare can go up or
6 down, I mean in the aggregate. I don't necessarily mean
7 every single consumer.
8 Now, Firm 1 -- why would that work? Firm 1 --
9 there's sort of an interesting effect here. Firm 2 has
10 a tougher job with bundling than under independent
11 pricing because it has to convince consumers to buy B
12 from it at the expense of them having to pay a higher
13 price for A.
14 Under independent pricing, it didn't have this
15 problem. In this set-up here, Firm 2 lowers its price
16 of B because it is now competing, trying to pull people
17 out of the bundle from Firm 1, which it didn't have to
18 do under independent pricing.
19 Firm 1's best response to that is to set an a la
20 carte price for B which is lower as well so B-only
21 consumers are better off in this setting here.
22 If you look at the people buying the bundle, it
23 is not clear whether they are individually better off or
24 not. Usually some are worse off.
25 In that setting, B-only consumers are always

1 better off. A and B consumers may be, may not be.
2 Aggregate consumer welfare can go up or down.
3 There is an interesting permutation of this for
4 either entry deterrents, if that's how you want to think
5 about this, or driving firms to another market.
6 Since Firm 2 always sets a lower price of B
7 because it has to work harder to capture consumers
8 because they will be tempted to buy B to get a lower
9 price of A, it always charges a lower price, its cash
10 flow is lower. Depending on the costs it may have, it
11 may in fact exit the market.
12 Look at this from another way. Imagine that
13 Firm 2 has not yet entered the market but it is thinking
14 about doing that and asking itself what would happen if
15 I did enter the market.
16 Well, the story I have gone through here depends
17 on a result which is in the paper that Firm 1's best
18 response to entry by Firm 2 is always to bundle.
19 Firm 2, if it hasn't entered yet, knows if it
20 does, Firm 1 will respond by bundling. Therefore, if
21 there is some cost of entry specific to the active entry
22 that Firm 2 had to incur, they may be deterred from
23 entering, somewhat like the one in the tying literature,
24 the paper by Mike Winston.
25 But there is a difference. You recall that

1 Mike's entry deterrence result depends on the equivalent
2 of Firm 1 giving a precommitment to a time, meaning if
3 an entry were to occur, it has to precommit to the tie.
4 There is no precommitment requirement because
5 bundling is what Firm 1 will want to do anyway, the best
6 response. So it is possible to induce Firm 2 to exit
7 even without the precommitment assumption of Winston and
8 others in the tying literature.
9 For a long time in this more complicated set-up,
10 I didn't think we were going to get any sort of fact
11 pattern that would tell us we had a safe harbor here the
12 way we did in the previous story that I just told.
13 My coauthor, David Wrightman, actually came up
14 with one. A sufficient condition in this set-up for
15 consumer welfare to be higher under bundling than under
16 independent pricing, assuming Firm 2 does not exit, is
17 the following.
18 If the a la carte price of A or the
19 out-of-bundled price of A is no higher than it would be
20 under independent pricing and if Firm 2's price for B
21 falls, then whatever happens with the bundle, we can
22 infer consumer welfare has to have gone up, even though
23 the price of B in the bundle may be a little higher.
24 So if we have this fact pattern, we can conclude
25 not only that overall consumer welfare is higher but in

1 fact every single consumer is better off.
2 A couple of remarks here. I talked about two
3 kinds of safe harbor tests here. The previous result or
4 model were the B markets perfectly competitive, and we
5 compare the a la carte price of A under bundling to the
6 monopoly price of A and we have a result.
7 And in this case we do the same thing. We can
8 only do that if there is a preexisting independent
9 pricing regime followed by an onset of bundling.
10 And in practice you may not find such a clean
11 set-up. Perhaps bundling began in 1932 or something
12 like that. However, in a litigation setting, the
13 chances are reasonably good that you will run up against
14 this set-up.
15 Typically what happens is firms compete, and one
16 of them will start bundling, and then there is an
17 antitrust complaint. Typically there is a before and
18 after if things make it to the litigation stage.
19 Let me contrast this with the doability of
20 Barry's test. Barry's test does not have the problem of
21 needing to find a before and after situation.
22 It basically lists as attributes the discounts
23 to the competitive line and asks if an equally efficient
24 competitor could undercut that. We could use that in
25 principal using data from the firms if we didn't have

1 any reason to think that was a strange point in time to
2 consider.
3 The advantage of -- Barry has a safe harbor, and
4 it's really oriented towards saying when do we exclude
5 competitors. That doesn't necessarily mean consumer
6 welfare is lower if in fact this test has failed.
7 Okay. To sum up, then, in the right
8 circumstances, at least, it seems possible that simply
9 by looking at pricing patterns in order to prepare
10 out-of-bundled prices so the monopoly must carry them to
11 the preexisting prices or by allocating discounts to the
12 competitive line, we do have some safe harbor tests at
13 this point, most of which weren't around or at least
14 weren't understood by us at the time of LePage's.
15 Okay, thank you.
16 (Applause.)
17 MR. DEGRABA: Our last presenter for the morning
18 is Joe Kattan.
19 He has asked that I waive the reading of his bio
20 and simply say he is a partner at Gibson, Dunn &
21 Crutcher in Washington, D.C.
22 MR. KATTAN: Thank you. I will also waive the
23 use of PowerPoint, the pervasiveness of which may be
24 testament to the bundling of the Microsoft Office Suite.
25 I'm a lawyer, too, and I'm going to look at

1 things from the perspective of the lawyer. And I want
2 to start out with a fairly obvious proposition which is
3 that both bundling and loyalty discounts involve price
4 cutting.
5 This is an area which U.S. law has tread very
6 carefully, and for a good reason. The cost of error in
7 this area, as we all know, is deterring firms from
8 engaging in aggressive price cutting, which the courts
9 have been loathe to do, viewing such deterrents as
10 antithetical to the goals of antitrust.
11 Justice Breyer back when he was in the First
12 Circuit captured this idea in the Barry Wright case,
13 where he said, "The consequence of a mistake here is not
14 to force a firm to undergo a legitimate business
15 activity that it wishes to pursue. Rather, it is to
16 penalize appropriate competitive price cuts, perhaps the
17 most desirable activity from an antitrust perspective
18 that can take place in a concentrated industry where
19 prices typically exceed costs."
20 This has been the foundation of U.S. antitrust
21 policy in the price arena. We have obviously seen that
22 in a number of Supreme Court cases in the predatory
23 pricing area, where the Supreme Court said that cutting
24 prices to increase business is the very essence of
25 competition.

1 Although this policy has its underpinnings in
2 the predatory pricing area, at least from a narrow legal
3 perspective, it is important to note that the Supreme
4 Court has made it clear that this policy has a broader
5 applicability.
6 This point was made in the Arco versus USA
7 Petroleum case which involved, as you all know, maximum
8 RPM, where the court said in the context of pricing
9 practices, only predatory pricing has the requisite
10 anticompetitive effect.
11 The reason for that it said was that low prices
12 benefit consumers regardless of how those prices are
13 set, and so long as they are above predatory levels,
14 they do not threaten competition.
15 We have adhered to this principle regardless of
16 the type of antitrust claim involved.
17 So at least from the legal perspective, we have
18 to start from the standpoint that discounting practices,
19 regardless of their form, can only violate the law when
20 they result in some form of predatory pricing.
21 Obviously there are economic models that attempt
22 to show how various discounting practices can harm
23 consumers, sometimes even when price exceeds cost.
24 But the courts have stubbornly clung to this
25 bright-line standard. And the reason for that is that

1 courts have been loathe to sacrifice the immediate
2 benefits of a price cut for the much more speculative
3 possibility that some future harm to competition might
4 be avoided if we curb the ability of firms to discount,
5 at least in the absence of more tractable and, more
6 importantly, more general economic models that can
7 predict harm.
8 Essentially what the courts have said, we like
9 the bird in the hand, the immediate price cut, much more
10 than the birds in the bush, which is the possibility
11 that at some point down the line we may have a more
12 competitive market and lower prices.
13 This obviously embodies assumptions about the
14 efficiency of progressive price cutting and about the
15 cost of false positives.
16 Regarding efficiencies, the courts are assuming
17 that price cuts that remain above cost enhanced both
18 consumer and total welfare. And with regard to the cost
19 of false positives, what the courts are saying is we are
20 worried very much about inhibiting price cutting that we
21 view is the essence of competition.
22 There are clearly several worries that the
23 court's fixation with false positives has made them
24 insensitive to the possibility of false negatives.
25 The basic critique is that anticompetitive

1 pricing conduct involving mixed bundling, involving
2 loyalty, is likely to be more pervasive and more
3 permanent than predatory pricing, so that the risk of
4 underdeterrents is greater than in the predatory pricing
5 area where this policy has its roots.
6 The reason for this, and I think we have heard
7 some of it today, is that while predatory pricing often
8 requires a large profit sacrifice, uncertain possibility
9 of recoupment, which leads to the predation approach not
10 being tried very often, anticompetitive bundling or
11 loyalty rebates could -- and I want to underscore
12 "could" -- entail in profit sacrifice or alternatively
13 enable instant recoupment.
14 For that reason they are more likely to occur.
15 For that reason, they are also more likely to be
16 durable, which is to say it can go on for a long time.
17 To me, the absence of a profit sacrifice would
18 also suggest, at least in the realm of pricing and what
19 we are talking about here is pricing -- not talking
20 about blowing up a competitor's factory or lying to a
21 standard-setting body -- is that an equally efficient
22 competitor would be able to match the discounts as a
23 general proposition.
24 We have heard about some exceptions and that to
25 the extent that the rivals are excluded, they are being

1 excluded on the basis of superior efficiency.
2 In addition, I think we have to take into
3 account the pervasiveness of bundling, the pervasiveness
4 of discounts that have a retroactive feature, which is
5 to say you hit a threshold and the discount applies to
6 it for marginal units.
7 Volume discounts are fundamentally structured
8 that way. Buy a hundred units and you get 10 percent
9 off is a fairly common form of doing business.
10 The pervasiveness of these types of practices
11 throughout the economy, the prevalence of their use by
12 firms that don't have market power and have no hope of
13 excluding competitors would suggest or at least caution
14 that there is a good possibility that the efficiency
15 explanation for these practices is the dominant one.
16 Now, there are models that show that equally
17 efficient competitors can be excluded even without a
18 sacrifice of profits.
19 But I think the issue with these models is that
20 they don't necessarily show consumer welfare being
21 reduced by the discount. In fact, I think some of the
22 models depend on consumer welfare being enhanced. I
23 guess we are really in the dark about this area of the
24 law.
25 Some of these models depend on consumers

1 actually being better off with the bundled price
2 offered. What we see is that both producer surplus and
3 consumer welfare is better off.
4 So what this shows is that there are
5 circumstances in which bundled pricing can harm
6 competitors, even efficient competitors, but they don't
7 necessarily harm consumer welfare.
8 Another question is whether these models at this
9 point are sufficiently general to support changing the
10 current legal regime.
11 Professor Hovenkamp argues that they are not,
12 that they cannot support a legal standard. What he says
13 is that the economic modeling showing that certain
14 discounts can be anticompetitive tend to be highly
15 complex, often making unrealistic assumptions.
16 The result is proposed legal standards that make
17 impossible informational demands on the courts.
18 A more benign way of looking at this is the
19 early models that have questioned the conventional
20 thinking and basically challenged the Chicago view have
21 worked with stylized assumptions to knock down at least
22 the universality of the received wisdom and more work
23 needs to be done before we know whether the results can
24 be generalized enough to support a rule of law, whether
25 basically what we have are some interesting footnotes

1 that show that the current legal regime can lead to
2 false negatives under some severe assumptions.
3 To base a rule of law on the economic models, we
4 have to have general models on which we can base clear,
5 predictable and administrable rules. Models that show
6 that anticompetitive results could happen are not good
7 enough to prescribe rules of law.
8 What we need are models that identify the
9 particular circumstances in which aggressive pricing is
10 likely to be anticompetitive and do so in a way that can
11 be reliably administered within the constraints of legal
12 factfinding.
13 The challenge is to have rules that capture the
14 circumstances in which discounts harm competition, rules
15 that do not discourage price cutting and do not serve as
16 an instrument for strategic behavior by rivals to attack
17 discounting by more efficient competitors, rules that
18 offer sufficient guidance to business executives to
19 enable them to respond and can be administered within
20 the constraints of legality.
21 We need rules that are general, sufficiently
22 general to have application beyond a narrow range of
23 stylized assumptions, do not lead to incidents of false
24 positives, are capable of application by business
25 executives, capable of implementation with the types of

1 evidence that are available to us in the litigation
2 setting rather than some idealized laboratory setting.
3 The virtue of the cost-based test as a starting
4 point or as an initial screen for analyzing pricing
5 practices -- and that would include bundling and include
6 loyalty discounts -- is that it does all of the above.
7 It is highly general in distinguishing between
8 discounting to reflect a seller's superior efficiency in
9 price cutting that has the potential to drive out an
10 equally efficient competitor.
11 It avoids false positives by limiting liability
12 to cases in which it is economically rational to incur a
13 profit sacrifice in the hope of subsequent recoupment,
14 following exclusion of a rival from a market.
15 It also sets a very understandable guideline for
16 business executives, what they need to understand is
17 their own cost, the cost of producing the goods that
18 they make. They don't need to understand what the cost
19 of their rivals are. They don't need to have a more
20 detailed understanding regarding the consequences of
21 their business conduct on market performance.
22 The test is administrable, because determining
23 average variable cost, which has been the measure of
24 costs used by the courts in most cases, which almost
25 always is going to be a good proxy for avoidable cost,

1 presents a relatively tractable problem, even though it
2 is a fairly complicated one, as anyone who has been
3 involved in any kind of cost analysis will tell you. It
4 leads to predictable results.
5 One cannot overemphasize the importance of
6 generality, predictability and consistency. Unclear or
7 open-ended rules can have some serious negative effects
8 because in and of themselves they can deter firms from
9 engaging in discounting.
10 In fact, predictability is the reason why the
11 predatory pricing test is a test that's grounded in a
12 price-cost comparison rather than being a true profit
13 sacrifice test.
14 A true profit sacrifice test would condemn
15 failing to maximize short-term profits. It would
16 condemn failing to recover the opportunity cost
17 associated with particular pricing behavior. And the
18 reason we don't do that is that a rule like that would
19 make pricing decisions by firms with large market shares
20 basically a roll of the dice.
21 So we have a clear rule that omits, I think,
22 false negatives but one that is administrable and
23 enables firms to base pricing decisions on an objective
24 measure that is easy to follow.
25 Now, what does all this mean in the context of

1 the practices that we are talking about here? What
2 would a plaintiff have to show in challenging a
3 multiproduct discounting?
4 The first thing a plaintiff has to show is it
5 cannot offer the multiproduct bundle either on its own
6 or in cooperation with other firms. If the plaintiff
7 can match the entire bundle alone or cooperatively, the
8 bundle is incapable of excluding, at least by virtue of
9 being a bundle, other than on the basis of superior
10 efficiency.
11 It can obviously ask whether the price of the
12 entire bundle exceeds the cost of the entire bundle.
13 But the bundling doesn't give the bundling firm a lever
14 over its rival because we don't have the asymmetry of
15 the ability of the rival to match a component of the
16 bundle.
17 To the extent that an equally efficient
18 competitor cannot match an offer because consumers are
19 better off with a bundle than from a la carte purchases,
20 any exclusion that might occur, and we have heard that
21 it might occur based on perhaps differentiated demand
22 for the products included in the bundle, may show harm
23 to a competitor, but they would not show harm to
24 consumers.
25 The same principle I think would apply, as

1 Professor Hovenkamp has argued, to single-product
2 discounts if the price charged by the defendant is above
3 cost.
4 That should be the end of the story. If the
5 plaintiffs can show that it can't match the bundle
6 either alone or cooperatively, then I think the Ortho
7 test is probably today the best means that we have for
8 identifying whether harm to competition may occur, if
9 allocating the discount to the competitive product
10 yields an above-cost price that is no more exclusionary
11 than having the bundling firm price the competitive
12 product on that stand-alone basis.
13 If the bundling firm flunks that test, then we
14 need to look at a couple of other things. One is has
15 the price been extended to a sufficient share of the
16 market to result in exclusion, because unlike the
17 classic predatory pricing situation, where the predatory
18 price is extended across the entire market and every
19 unit is sold below cost, mixed bundling discounts may be
20 extended on a selective basis.
21 Critics of bundling cite this as evidence that
22 the strategy is less costly than predatory pricing. By
23 the same token, it also tells us the strategy is less
24 likely to exclude.
25 It is also tempting for plaintiffs to focus on

1 what happens at the margin, at some point which is near
2 the threshold that triggers the discount.
3 To use an example from the Concord Boat case, in
4 that case a defendant offered a graduated discount. The
5 first level was 1 percent if a consumer bought 60
6 percent of its requirements from Brunswick.
7 Now, obviously, if you look at this from the
8 standpoint of a hypothetical consumer who otherwise
9 would buy 59 percent of its requirements from Brunswick,
10 then you could say the last 1 percent is being given
11 away for free and that is surely below cost. And that
12 observation is as irrelevant as it is true.
13 To compete for just 10 percent of a buyer's
14 requirement, an equally efficient competitor would have
15 only had to extend a 6 percent discount to match the
16 Brunswick offer in that case. And obviously an equally
17 efficient competitor can match the offer to compete for
18 the entire amount of the business, in which case its
19 discount doesn't need to be any larger than the
20 Brunswick discount.
21 It has to match the discount dollar for dollar,
22 which is a 1 percent discount.
23 I think it is also important to take the
24 duration of arrangements into account. Supporters of an
25 interventionist approach assume that bundling loyalty

1 discounts can go on forever because of the absence of a
2 profit sacrifice.
3 In a litigation setting, this is an empirical
4 question. We know in the exclusive dealing arena, the
5 law presumes that arrangements of a year or less are
6 presumptively legal.
7 Where we are talking about an arrangement that
8 does not require exclusivity but simply offers an
9 economic incentive to buy more from the seller, the same
10 presumption should be applicable here.
11 Finally, I would say the plaintiff has to show
12 real rather than conjectured harm. This means exclusion
13 of the plaintiff that results in harm to consumers. We
14 have seen in too many cases -- Ortho being one of them,
15 but there are many others -- the spectacle of a
16 plaintiff that is actually doing well in the
17 marketplace, claiming that a rival's pricing practices
18 are making it hard for it to compete, that it would have
19 done better.
20 "I would have done better" shouldn't be the
21 basis for a monopolization. The basis for a
22 monopolization case ought to be exclusion.
23 Again, there are models that attempt to rebut
24 the Chicago thesis. Maybe down the road they would call
25 for a reevaluation of the law, but I think at this point

1 they are too ambiguous in terms of impact on consumer
2 welfare and too limited in their assumptions to support
3 a change in the legal regime.
4 Thank you.
5 (Applause.)
6 MR. DEGRABA: We are at the break portion of our
7 morning festivities. It looks like we should get back
8 here in about 10 minutes.
9 We will reconvene. It is 11:00 now. So 11:10.
10 (Recess.)
11 MR. DEGRABA: Welcome back. We will continue
12 for about 50 more minutes.
13 This is the sort of the moderated discussion
14 part of our day, where we will present a number of
15 propositions up here on the slides.
16 These propositions are not meant to represent
17 necessarily the views of the Commission. They are
18 simply statements made to generate some discussion.
19 But before we move to the propositions, I want
20 to go through each of the presenters and ask if any of
21 the presenters want to respond to anything any of the
22 other presenters said.
23 So we will start in the same order that we did.
24 So we will ask Barry. Is there anything you
25 want to say in response to something someone else said?

1 PROFESSOR NALEBUFF: I guess I was a little
2 disappointed in the lack of response in terms of the
3 presentation we had from Mr. Kattan in the sense of I
4 think it is manifestly the case that bundled discounts
5 do not mean lower prices, and that's actually a
6 distinguishing feature of them.
7 The example I gave you, historical prices that
8 had always been charged for these goods that you saw
9 sort of 1, 2 and 3, suddenly the firm says if you don't
10 buy all of my goods, now this competitor, I will raise
11 them substantially.
12 In fact, the evidence would suggest that I'm
13 going to raise them above what would be the monopoly
14 level.
15 It is really a case of if you don't give me your
16 wallet, I'm going to shoot you. To say that is now good
17 for the consumers because they have the absence of being
18 shot and calling that a discount strikes me as just a
19 perversion of what's really going on here.
20 The fact is that when you do predatory pricing,
21 you actually buy the stuff cheaply. But when you see a
22 bundle, quote, "discount," it is not required that the
23 customer actually was ever paying that high price. It
24 is only that they weren't being threatened to be charged
25 that high price.

1 That is a fundamental distinction which has to
2 be recognized, and it is one of the reasons why we want
3 to treat these things differently.
4 It is also, of course, central to David Sibley's
5 perspective of when we see the price being raised for
6 the single product by the absence of the bundle, that
7 really should set off alarm bells.
8 In terms of Tom's presentation, just one thing
9 to observe is there are times when the purpose of the
10 exclusion is not to raise the price in the B market.
11 And in particular, there are cases I have seen
12 where firms would never be able to raise the price of B,
13 would always be competitive, but nonetheless, equally or
14 more efficient B firms were excluded because that was
15 going to be the platform for them to come into the A
16 market and, therefore, attack monopoly, because it would
17 be establishing sales force, establishing manufacturing
18 in that territory.
19 So one has to look not just at the potential of
20 the B market to be monopolized but what is the purpose
21 of the exclusion here.
22 MR. DEGRABA: I will give Joe a chance to
23 respond to the statement that bundled discounts don't
24 always mean lower prices.
25 Joe, do you want to respond to that at all?

1 MR. KATTAN: It is certainly an empirical
2 proposition that can be tested, whether bundled prices
3 or unbundled prices represent an increase in the price
4 vis-a-vis the price levels that prevail in the absence
5 of the bundle.
6 I have not seen evidence suggesting that that's
7 the pervasive way in which we encounter bundled
8 discounts.
9 Now, is it theoretically possible to set up a
10 construct that says here is what a seller can do, it can
11 jack up the prices on an unbundled basis and offer a
12 discount that simply takes you back to where you would
13 have been in the absence of the bundle.
14 Yes, that is obviously arithmetically plausible.
15 But the question is how common is that empirically and
16 whether that is something that in the context of
17 litigation also lends itself to the kind of proof that
18 we have in the litigation setting, particularly when you
19 have changes in quality, performance, product attributes
20 that may take place over the same period of time.
21 MR. DEGRABA: Thank you.
22 And Tom Lambert, do you want to respond to the
23 exclusion doesn't always mean an increase in the price
24 in the B market?
25 PROFESSOR LAMBERT: Sure. May I bundle my

1 response?

2 MR. DEGRABA: Is somebody controlling the volume

3 on this thing? Let's continue.

4 PROFESSOR LAMBERT: I will bundle my response to

5 Barry, along with my comments.

6 Joe began by quoting the Barry Wright case, and

7 I believe that that is absolutely spot on in this

8 context. So I will quote a bit from that.

9 Then Judge Breyer writes, "Unlike economics

10 laws, an administrative system, the effects of which

11 depend on the content of rules and precedents only as

12 they are applied by judges and juries in courts and by

13 lawyers advising their clients."

14 And here is the key part. "Rules that seek to

15 embody every economic complexity and qualification may

16 well, through the vagaries of administration, prove

17 counterproductive, undercutting the very economic ends

18 they seek to serve."

19 So my response to Barry's two points, one is the

20 point that he makes in response to Joe, that you could

21 have these phony discounts where you have jacked up the

22 price and then said "hey, we are giving you a discount,"

23 and he seems to think those are very pervasive, it seems

24 to me that most of the bundled discounts I see are not

25 like that at all.

1 McDonald's, go to McDonald's.
2 PROFESSOR NALEBUFF: They are not the ones the
3 antitrust cases are about.
4 PROFESSOR LAMBERT: Correct, but they are the
5 ones that are affected if we adopt a rule of law that is
6 designed to deal with .0001 percent of bundling cases.
7 That to me is troubling and it's exactly what Judge
8 Breyer is talking about in Barry White.
9 Sometimes we have to sacrifice the last 1
10 percent to protect the 99 percent.
11 It also seems to me that we could deal with
12 those cases by -- the legal rule I propose presumes the
13 legality of above-cost bundled discounts.
14 It seems to me that it would be possible -- and
15 I think Joe mentioned this in his talk -- to identify a
16 phony discount. If you see a price jack and then a
17 discount, well, that's not really a discount.
18 So we could withhold the presumption of legality
19 for that type of bundled discount.
20 And then I guess I would make the same point
21 with respect to Barry's argument that sometimes bundling
22 is done not to charge supercompetitive prices in the B
23 market, foreclose competitors and get monopoly power in
24 that market but instead to monopolize the A market.
25 That very well may be the case, and this is

1 incredibly casual empiricism, but my guess is that
2 doesn't happen enough to justify writing a law, a rule
3 that is so complex that it chills the procompetitive
4 bundled discounting.
5 I am very much motivated by this idea that we
6 have to make these theories workable as laws,
7 understandable, administrable by juries and judges and
8 useful to counselors who are advising their clients.
9 MR. DEGRABA: Thank you.
10 David, do you have any comments on anybody's
11 presentations?
12 PROFESSOR SIBLEY: Yes. This is more in the
13 nature of something I meant to say but forgot rather
14 than a comment.
15 One thing that motivated some of the original
16 work that Greenlee and Wrightman and I did on bundled
17 discounts was try to figure out as nonlawyers what
18 branch of antitrust law was it appropriate to use in
19 analyzing these.
20 We concluded predatory pricing wasn't the right
21 branch. For a while we thought that tying was. The
22 reason for that is if the B market is perfectly
23 competitive and the A market is a monopoly, the only
24 function of the bundle discounts is to set an
25 out-of-bundled price of the monopoly product so high

1 that consumers are faced with a choice of buying at high
2 bundled prices or buying the competitive product and
3 buying none of the monopoly product at all.
4 That is really equivalent to a tie.
5 The version of the model which involved two
6 firms offering differentiated products tells us that no,
7 there is lots more going on with bundled discounts than
8 simply being equivalent to a tie.
9 The out-of-bundled price on my third slide
10 wasn't in place simply to force people to face the
11 option of buying the B market at a competitive price but
12 no A or buy the bundle at outrageous prices.
13 It actually played a price discrimination role
14 and people buy at that price. That suggests to me that
15 if there is a general legal theory of bundled discounts
16 to be had, it is not predatory pricing and it is not
17 always going to be the same as tying either.
18 It is going to be something else, and I don't
19 know what it is.
20 I would like to comment on something that both
21 Joe and Tom said about sort of requirements that the
22 plaintiff would have to meet in a bundled discount case
23 in order to prevail.
24 One of them was that the plaintiff would need to
25 show that it is impossible, either alone or with someone

1 else, to assemble a bundle that would match the bundle
2 being offered by the defendant in such a case. I think
3 that rule has a lot of appeal to it.
4 There is one big caveat. Of the many things we
5 have learned about bundled pricing from Barry, one of
6 them is that the more symmetrical firms are, the more
7 you would expect head-to-head competition to be very
8 severe.
9 If in fact a firm were able to match the items
10 in another firm's bundle, the result of that might
11 simply be low-profit dog-eat-dog competition bundle
12 versus bundle.
13 Knowing that to be the likely result, the firm
14 might not incur the cost of assembling that bundle in
15 the first place.
16 So it could well be that you could ask a
17 plaintiff why haven't you assembled a counterpart to the
18 defendant's bundle, and it seems perfectly possible, and
19 the plaintiff would say yes, it is perfectly possible,
20 it is just it would be unprofitable for me to do it
21 because all I'm doing then is bundling myself into a
22 price war and it is not worth the cost of doing it.
23 So I have a choice, either get into a price war
24 which isn't going to make any money or stay where I am
25 now and be excluded.

1 Although I think it is an appealing rule, you
2 could probably anticipate a come-back like that.
3 I do want to quibble some with the notion that
4 the existing models are simply too complicated or too
5 data intensive to say anything useful. Before I do, let
6 me make it clear I'm sure there are fact situations in
7 which that charge would be true.
8 But the test that Barry has advocated which is
9 sort of the refinement of the Ortho test, I don't think
10 it is any more complicated to implement that test to do
11 a lot of things that we do in antitrust cases.
12 I don't view that as having any incremental
13 complication or data requirements over and above things
14 we engage in any way.
15 Secondly, if you have a situation that is
16 analogous to what Greenlee and Wrightman and I looked
17 at, where there is a before and an after independent
18 pricing of model discount, really a test for consumer
19 welfare would simply be to say are the out-of-bundle
20 options that consumers face after the bundle discounts
21 are put into effect better or worse or the same as prior
22 to the bundling.
23 If the out-of-bundled price for A is no higher
24 than the previous price of A and if prices in the B
25 market are either the same are have gone down, then we

1 can infer that whether people take the bundle or not,
2 they can't be worse off and they are probably better off
3 than they were before.
4 That is not a complicated test. It does involve
5 some work, sure. It is a lot less complicated than a
6 number of things I have had to do in antitrust cases.
7 MR. DEGRABA: Thank you, Dave.
8 Joe, do you have any comments on anything that
9 was said here?
10 MR. KATTAN: Certainly.
11 I am wondering whether the second model that
12 David talked about is one that has antitrust
13 significance.
14 It certainly shows that a firm that's facing
15 differentiated demand in the second product market can
16 raise its profits by bundling not necessarily for the
17 purpose of excluding the second firm but simply in order
18 to extract more surplus.
19 But that usually does not fit within the
20 paradigm of antitrust cases. It is simply charging a
21 higher price of its consumers.
22 PROFESSOR SIBLEY: I would agree that if there
23 is no foreclosure effect, I probably wouldn't worry
24 about it.
25 Some of the -- the model does suggest there can

1 very well be, that the institution of bundling by Firm 1
2 puts the other firm in a situation where it has to
3 charge lower prices than it has before, and this can
4 make it viable.
5 MR. DEGRABA: Thank you.
6 We now move on to the propositions. Can I have
7 slide 2 up there, please.
8 We have assembled a set of propositions that we
9 will read and ask anyone who would like to comment on
10 them to comment. Some of them have actually been
11 covered at least in some part in some of the talks, but
12 we will go through these anyway.
13 The first proposition is single-product
14 discounts should be per se lawful if the overall price
15 for all units exceeds cost.
16 Is there anyone that disagrees with that
17 proposition?
18 PROFESSOR NALEBUFF: And, again, if it turns out
19 that somebody could replace another firm 100 percent,
20 sure, no problem.
21 But the Concord Boat case is a great one where
22 in fact there is evidence that they had a monopoly for
23 some share of the market based on installed base.
24 So it wasn't realistic. Maybe you could get 20
25 percent or maybe 50 percent of the market, but you

1 weren't going to get 100.
2 The chart that I showed you was also from other
3 cases like that. Do we think that rivals should always
4 have to do 100 percent replacement? That's a pretty
5 strong test for a firm that's not yet proven itself.
6 It may well be that incumbent buyers want to
7 only take 10 percent chance, 10 percent of their supply
8 before they decide to go whole hog in this.
9 So you have to ask do these discounts that go
10 back to volume 1 really provide an opportunity for
11 somebody to come in at a reasonable scale or not. If
12 the answer is no, then I think we have a problem.
13 MR. DEGRABA: Anyone else?
14 PROFESSOR SIBLEY: Let me comment on what Barry
15 said.
16 Barry, if the proposition were rephrased in the
17 following way, would you have a problem with it?
18 Single-product discounts are lawful if sellers, each
19 seller in the market can serve 100 percent of each
20 buyer's needs. In other words, each seller can bid for
21 all of each consumer's business. Then there shouldn't
22 be a problem, should there?
23 PROFESSOR NALEBUFF: They may have the capacity
24 to do it. It turns out it may well be the buyers are
25 unwilling to have a sole source, or they may be

1 unwilling -- the incumbent supplier might have a
2 monopoly over 40 percent, in which case the fact that I
3 could supply 100 percent and undercut them isn't really
4 relevant.
5 MR. DEGRABA: David, would your proposition be a
6 problem if there was a significant amount of product
7 differentiation amongst the competitors so that a
8 particular consumer may not be willing to switch 100
9 percent out of supplier A into supplier B?
10 PROFESSOR SIBLEY: Yes, I might have a problem
11 then because the buyer then is faced with competition
12 really only for all his business and the buyer might not
13 want that. Knowing that, one firm might end up with a
14 lot of that buyer's business, charging a higher price.
15 Really I guess it is only if everything inside
16 is as homogeneous as you would like and sellers are all
17 perfectly positioned to serve each buyer and there is
18 none of the stuff Barry was talking about, then it
19 should be okay without further ado.
20 MR. MEYER: Is there some increment of the
21 volume where it would be relevant to you that the price
22 is above cost?
23 In other words, if there is an installed base,
24 if you leave that out of it and ask about the
25 contestable units, would it be relevant if as to those

1 units the price is above cost overall?
2 PROFESSOR NALEBUFF: You have to ask is there
3 some normal, sensible way that a firm could come into
4 this.
5 If you can say the picture I first showed you, a
6 firm could only come in for below 5 percent of the
7 market in some sensible way, in some area between 30
8 percent and 50 percent.
9 That didn't strike me as a normal thing. The
10 other point is what's wrong with having significant
11 discounts on incremental units rather than going back to
12 01? You could achieve very similar objectives. We are
13 not stopping firms from cutting prices.
14 So I think in general, firms aren't going to
15 offer negative prices under that scheme, but they may
16 offer low prices over longer ranges. That strikes me as
17 pro consumer. Since I have another way of achieving
18 price discounting that doesn't have that exclusionary
19 effect, why not use it?
20 MR. KATTAN: I think the same logic would apply
21 to simple volume discounts, say if you buy 100 units, I
22 will give you 5 percent off. That has exactly the same
23 effect as something that may be more individually
24 tailored.
25 If you look at Concord Boat, you can see that

1 the rivals there didn't have to compete for very much
2 business in order to -- unless you assume that 6 percent
3 discount would have forced them to be below cost. They
4 wouldn't have to compete for very much business to be
5 able to recover their cost and compete against the
6 discount.
7 I think the other issue is how do you determine
8 which is the inframarginal business that you are going
9 to say this is not contestable, it is sacrosanct, it
10 belongs to the monopolist and they are really competing
11 only the following units which are incremental units to
12 which we would allocate the costs. I think that gets to
13 be incredibly complicated because in most cases it is
14 not going to be clear what is inframarginal and what's
15 marginal.
16 PROFESSOR NALEBUFF: The solution is to ask for
17 an equally efficient firm, the monopolist itself, what
18 units could it compete for. You can see what range it
19 is.
20 If it turns out the discount is small enough, as
21 it may have been in Concord Boat, so that a large range
22 of entry is possible, I'm not worried about it. It is
23 an empirical question.
24 You can say 1 percent doesn't work, 5 percent
25 does, up to 30 percent does, but you can't go beyond

1 that. Okay. So show what the range is based on what
2 these discounts create.
3 PROFESSOR SIBLEY: Let me point out, really
4 supportive of Barry's feeling, that this really isn't
5 all that undoable. There has been a fairly recent -- I
6 know that antitrust or patent was used, but in a case I
7 was involved in in which we had discounts like this.
8 You can calculate which units have negative
9 prices associated with them and what level of entry you
10 would need to achieve if you were a new entrant and
11 wanted to cover costs. The prices do look bizarre, just
12 like Barry's picture, but it is really not that hard.
13 PROFESSOR LAMBERT: Can you do it ex ante if you
14 are the business planning to give a loyalty discount?
15 PROFESSOR SIBLEY: Ex ante, the picture is
16 actually somewhat easier. Right? It is one thing to
17 think about an incumbent being there and there are a lot
18 of reasons why incumbents are hard to unseat. Perhaps
19 you are dealing with a loyalty discount scheme, which
20 makes it tougher.
21 Ex ante, we could all be competing with loyalty
22 discount schemes.
23 PROFESSOR NALEBUFF: If you can't do it ex ante,
24 because it is so damn hard. If you as a seller can't
25 figure out what it is, the buyer will probably have

1 trouble, the rival would have trouble.
2 I would hope that a firm who is setting a price
3 could actually figure out what its profits are at
4 different levels.
5 MR. KATTAN: I think the reason the firm
6 offering the discount can't do it ex ante is it doesn't
7 know the scale at which the entrant is able to enter,
8 which is something known to the entrant, the firm
9 offering the discount.
10 I think part of what we need to do here is to
11 make sure that the test that we apply is one that is
12 based on information which is available to the firm
13 that's offering the discount and doesn't depend on
14 things that are outside of ability to know or control.
15 MR. DEGRABA: Thank you. We will move on to the
16 next slide, slide number 3.
17 We have heard about this a little bit. The
18 LePage's decision's vagueness is likely to chill pricing
19 behavior that enhances consumer welfare.
20 I will ask sort of a two-part question, one to
21 the lawyers and one to the economists.
22 The one I want to ask the lawyers is so what
23 counsel are you giving to your clients, if at all, if
24 you have run into this problem or what other counsel
25 have you heard other attorneys giving to their clients?

1 For the economists, have there been any other
2 empirical studies or any other data in the market that
3 might suggest there's a problem? Anyone?
4 PROFESSOR LAMBERT: I'll start.
5 I think the answer -- the proposition is
6 correct. And if you want empirical evidence, it is not
7 very rigorous, but go to Google and enter "client alert
8 LePage's," and you will end up with pages of client
9 alerts from law firms saying "warning, this practice is
10 potentially troubling, be very, very careful," blah,
11 blah, blah.
12 It is likely, I believe, that that means there
13 is a chilling effect.
14 In terms of counsel to clients, I would say give
15 bundled discounts at your own risk, be very, very
16 careful before you do it, and you might want to think
17 about whether your rivals could compete with those
18 discounts, even if your discounted price is above your
19 cost.
20 Another piece of advice that I would give is
21 something that Barry mentioned, I think -- maybe not --
22 and this is based on the Johnson & Johnson versus
23 Applied Medical case.
24 PROFESSOR NALEBUFF: I mentioned it.
25 PROFESSOR LAMBERT: I knew you did but I wasn't

1 sure if it was in private conversation.
2 In the Johnson & Johnson versus Applied Medical
3 case, Johnson & Johnson was giving bundled discounts
4 primarily to compete against an equally diversified
5 rival, U.S. Surgical, a small, less diversified rival,
6 Applied Medical, and several others who couldn't compete
7 because they didn't sell the full product line.
8 And after receiving complaints, Johnson &
9 Johnson responded by carving out the purchases of those
10 smaller rivals. And nonetheless, Johnson & Johnson got
11 sued by Applied Medical even after this act of
12 generosity.
13 The judge granted summary judgment in favor of
14 Johnson & Johnson on the basis of those carve-out
15 purchases. So this does seem to be a way that a company
16 can protect itself.
17 MR. KATTAN: I certainly agree that the
18 vagueness of LePage's is problematic.
19 I think one of the things that is not clear from
20 LePage's -- and when I have talked to people who have
21 been associated with the case, I have gotten different
22 answers on this -- is whether 3M simply showed that the
23 price of the total bundle exceeded cost or whether it
24 actually passed the Ortho test.
25 People who have studied the record tell me that

1 they don't think that 3M passed the Ortho test. That
2 still creates a problem for us because the burden of
3 proof normally would be allocated to the plaintiff to
4 show that the Ortho test wasn't met.
5 But to the extent that this is a case where the
6 discounts allocated to the competitive products resulted
7 in a below-cost price, it may be less exceptional than
8 we think it is and we just need to wait and see how the
9 law develops in this area.
10 MR. DEGRABA: Joe, could you articulate what the
11 Ortho test is for anybody in the audience who doesn't
12 know.
13 MR. KATTAN: It says that we will allocate the
14 discount in a multiproduct bundle discount to the
15 competitive product.
16 So the example would have been the shampoo and
17 conditioner example that I think Tom used in his
18 presentation.
19 In this case, the question was whether
20 allocating the discount to the generic transparent tape
21 would have resulted in an above-cost or below-cost
22 price. I gather that the record is silent on that
23 issue.
24 So it may be simply -- what the case may come
25 down to, then, is really who bears the burden of proof

1 in showing whether the Ortho test has been satisfied as
2 opposed to some of the broader readings that have been
3 given to the case as basically setting a formless and
4 vacuous test for exclusion and a Section 29 test.
5 MR. DEGRABA: Thank you.
6 You want to say something, David?
7 PROFESSOR SIBLEY: I don't know whether LePage's
8 has had a chilling effect or not because to answer that
9 question, I would have to know all the firms that have
10 thought about doing loyalty or bundled discounts but
11 have chosen not to.
12 I will simply observe that there are antitrust
13 cases going on now or recently concluded which, if you
14 believe the plaintiffs in those cases, involve firms
15 that have been engaging in bundled discounts in time
16 periods subsequent to LePage's.
17 It may have chilled such activities in some
18 senses, but it certainly hasn't stopped them.
19 MR. DEGRABA: We will move on to the next slide,
20 please.
21 PROFESSOR NALEBUFF: One more comment.
22 One should also take the perspective that the
23 vast majority of bundled discounts that we see out
24 there, whether it be the Happy Meal at McDonald's and
25 the like, wouldn't come close to the test we are

1 describing here in terms of leading to incremental
2 products being below cost.
3 Those in my view are just red herrings in terms
4 of thinking about the type of bundled prices that you
5 would see. They are not affected by LePage's and they
6 are just not relevant for any discussions we have here.
7 MR. DEGRABA: Okay. Our next proposition is a
8 bundled rebate or discount can exclude an equally
9 efficient single-product competitor, even if the
10 postdiscount price of the bundle as a whole is above
11 cost.
12 We have talked about that at some length here.
13 There is actually kind of two off-shoot questions I want
14 to talk about.
15 The first is what happens if we instead of
16 looking at existing competitors in the market, what if
17 we were to also consider entry deterrents. How would
18 entry deterrents be considered in this proposition?
19 PROFESSOR NALEBUFF: I have written on that. In
20 the paper in the quarterly Journal of Economics, the
21 challenge is that same rebate gets to be used in
22 multiple dimensions, and, therefore, it makes it less
23 profitable for somebody to come in.
24 It is also rational that a firm would want to do
25 that rebate and do that bundling in the face of

1 competition.

2 It is also the case that it limits the potential

3 market of a rival to consumers who like that entrant's

4 product and don't like the A product and therefore can

5 shrink the potential market available to an entrant.

6 Bundling is one of the most effective tools to

7 prevent entry that we know, I think.

8 PROFESSOR SIBLEY: Let me follow along with what

9 Barry is saying.

10 In the last line of my talk, when I had the two

11 firms offering differentiated product, it is not only

12 the case that it is possible to exclude an equally

13 efficient B competitor in that set-up where the overall

14 price of the bundle exceeds the cost of the bundle.

15 In fact, the individual prices would all be

16 higher than costs as well. In no sense are you pricing

17 below cost, and, yet, you can exclude an equally

18 efficient competitor.

19 MR. KATTAN: I think the question is whether in

20 these models that show that an equally efficient

21 competitor can be excluded, consumers are better off or

22 worse off.

23 At least as I read the exclusionary bundling

24 paper by Professor Nalebuff, in one of the examples he

25 gave with the A and B products with one of his

1 propositions today actually showed that both consumer
2 welfare and producer surplus go up.
3 So total welfare goes up, consumer welfare goes
4 up, and yet an equally efficient competitor gets
5 excluded.
6 And the question is do we want an antitrust
7 policy that says that we are going to punish firms for
8 conduct that actually raises consumer welfare.
9 PROFESSOR SIBLEY: I think we are not to
10 punish firms for conduct that raises consumer welfare.
11 The sort of policies at least the economists at
12 the table have been talking about are not policies which
13 are finely designed enough so they attempt to root out
14 consumer welfare reducing activities, consumer welfare
15 increasing activities, but simply to construct safe
16 harbors. That is, if the following is true, then
17 consumers are not harmed.
18 It does not mean that if the following is not
19 true, they are benefitted necessarily or are harmed.
20 But at least the safe harbor test we have been
21 talking about I think are on sound ground there.
22 By the way, you asked earlier about examples of
23 what Barry was talking about in terms of bundled
24 discounts just involving sort of fictitious discounts.
25 Barry went through a pharmaceutical example.

1 Who are the firms in that one, the Keflin and the rest
2 of it?
3 PROFESSOR NALEBUFF: That was SmithKline and
4 Lily.
5 PROFESSOR SIBLEY: That's a case where the
6 discount was in some sense fictitious.
7 What the defendant did there was to raise the
8 out of bundled price 3 percent and give them a 3 percent
9 discount on the bundle. That was pretty close to what
10 you have heard us talking about.
11 MR. KATTAN: My recollection is that that case
12 could be addressed by application of the Ortho test.
13 PROFESSOR SIBLEY: It was addressed by the
14 application of the Ortho test. The point is simply it
15 isn't just a figment of economists' imagination that
16 these things could happen. They did in that case.
17 MR. KATTAN: What you are citing is a 25-year
18 old case. If that's the only example we can come up
19 with in 25 years, I'm not persuaded that it is
20 pervasive.
21 The question is, do we need a test that is more
22 stringent than the Ortho test, or is the Ortho test
23 adequate to address the kind of concerns that have been
24 articulated through these models?
25 PROFESSOR SIBLEY: It depends on what your

1 concerns are. The Ortho test is a test designed to see
2 whether a single-line firm can undercut a bundle.
3 You can say if you want to call that a test of
4 anticompetitiveness, that's what it does. It gives a
5 sort of safe harbor.
6 The sorts of things that Greenlee Wrightman and
7 I talk about were not tests for that, does consumer
8 surplus go up or down, when can we be assured it only
9 goes up. There are circumstances under which it is an
10 easy test to do.
11 PROFESSOR NALEBUFF: The one place where Joe and
12 I do agree is what I proposed is really a modification
13 of the Ortho test.
14 There are some parts of the test that are
15 missing. For example, it turns out the right time to
16 apply the test is not ex post. It is ex ante. It is
17 when the consumer is trying to decide who to buy from.
18 Therefore, you have to use the anticipated
19 volumes, not the ex post volumes, which can often be a
20 challenge here. You also have to use the incremental
21 cost as opposed to thinking about what I'm selling, the
22 bundles or just selling things individually.
23 Subject to correcting for what expectation
24 should be and how you measure costs, actually I think it
25 is the way to go.

1 MR. DEGRABA: Let me skip ahead here to slide
2 number 7 because it is a related question.
3 The proposition here is loyalty discounts,
4 either single product or bundles, should never be
5 condemned without applying some kind of price-cost test.
6 Do you agree or disagree? Or kind of agree?
7 PROFESSOR SIBLEY: It kind of depends. If what
8 Barry and I call the B market is perfectly competitive
9 and the demand for A and B are independent and all that
10 sort of thing, then in that case you can say whether
11 consumer welfare has gone up or down or stayed the same.
12 Simply by comparing the out of bundled price to
13 the prebundled price, to the independent pricing level
14 of the monopoly good, you don't need to know anything
15 about costs.
16 MR. DEGRABA: Outside of the nice, clean test on
17 prices, is there any other conditions under which you
18 would condemn a bundled discount without a price-cost
19 test? Is this essentially a price-cost issue?
20 PROFESSOR NALEBUFF: I have this general matter
21 and issue where my price depends on what it is that you
22 buy from other people as a general statement, as opposed
23 to the price I charge you depends on what you buy from
24 me.
25 So that to me -- it is of the form I will charge

1 you one price if you buy from David and another price if
2 you buy from Joe.
3 I think that is problematic, as opposed to my
4 pricing depends on what you buy from me.
5 PROFESSOR SIBLEY: If I was going to use that as
6 a test, if I'm a bad guy and I want to charge you more
7 if you buy from Fred as opposed to me, can't I always
8 mimic an anonymous-looking thing just by appropriate
9 choice of quantity discount with grade points which
10 happen to exclude Fred?
11 PROFESSOR NALEBUFF: You can try and do that.
12 It is much more difficult to do it. I didn't claim
13 excluding that is going to be perfect. When you do it
14 directly, it is problematic and I shouldn't -- we should
15 know how.
16 MR. MEYER: If we grant you an exception for the
17 moment for discounts specifically or rebates
18 specifically keyed to purchases from identified
19 competitors, leave that off the table, is there some
20 kind of price-cost test safe harbor that you would
21 acknowledge is appropriate here?
22 PROFESSOR NALEBUFF: That first one is basically
23 a statement of my price to you depends on the market
24 share I get. My market share test is ultimately a test
25 that you don't buy from somebody else.

1 Those things are very common. They are not
2 exceptional out there.
3 MR. MEYER: You wouldn't limit your exception to
4 specifically identified purchasers? You would say if
5 there is anything that is keyed to how much the consumer
6 is buying?
7 PROFESSOR NALEBUFF: Not volume. Percent.
8 Ultimately --
9 MR. MEYER: If you have an estimate of the
10 customers' total needs, don't you also have an estimate
11 of their share?
12 PROFESSOR NALEBUFF: I have an estimate. The
13 price will depend on what they buy, an absolute amount,
14 not punishing them for buying something from another
15 firm.
16 MR. KATTAN: If you buy 800 units from me, you
17 get a 5 percent discount, that's okay, even if I say to
18 him if you buy 600 units from me, you get a 5 percent
19 discount?
20 PROFESSOR NALEBUFF: I'm much happier with that
21 than saying i will take away your discount if you buy
22 anything from David.
23 MR. MEYER: Defining this exception to mean
24 market share discounts, where do you end up after that?
25 PROFESSOR NALEBUFF: I think if you pass the

1 modified Ortho test, if you would like, so that the
2 incremental price, based on expected volumes and such,
3 is above the incremental average variable cost, you are
4 fine. And you are using your own cost in doing that
5 test. Because you could offer a competing B product by
6 itself without any difficulty.
7 MR. MEYER: Is there congruence, David, between
8 that statement and the situation you were describing of
9 the conditions where an increase in the out of bundled
10 price for A goes up or doesn't go up?
11 PROFESSOR SIBLEY: I guess in some sense. I
12 would want to think about that more. Simply saying buy
13 from Fred, pay a lot for A.
14 PROFESSOR NALEBUFF: I thought the question was
15 something else. I thought we all agreed on that safe
16 harbor, by the way, in terms of if the incremental price
17 for B compared in the A/B bundle story is sufficiently
18 high, then it actually isn't below the actual variable
19 cost to B, for the firm selling it, I think we all
20 believe you are in no danger.
21 The question is what about if that test isn't
22 passed.
23 PROFESSOR SIBLEY: If it isn't passed, then it
24 is hard to tell. It is not a simple test. At least I
25 personally don't have anything ready for primetime on

1 that.
2 MR. DEGRABA: Let's go back to slide number 5.
3 It says a loyalty discount that allows a competitor to
4 operate profitably at some scale can never be harmful to
5 consumers.
6 Basically what we want to know here is is the
7 sort of antitrust objections to loyalty discounts
8 strictly one of driving competitors out of the market or
9 can there be serious harm to consumers simply by
10 shrinking, if you will, some competitors' output.
11 PROFESSOR LAMBERT: I would say, just as a
12 factual matter, sure, there can be harm to competitors
13 and to consumers by shrinking the rivals' output through
14 a discount.
15 The problem is, beating a dead horse here, we
16 have to come up with a way to write a rule that
17 implements that notion, and that requires us to know
18 something about minimum efficient scale, which is almost
19 impossible to know.
20 So while I would concede that it is possible to
21 harm rivals and harm consumers by reducing the rival's
22 scale by usurping so much business from them with your
23 loyalty discount, nonetheless we should have this
24 Hovenkamp legality rule if the discounted price is above
25 cost.

1 It could be met by equally efficient rivals.
2 The discounting practice might actually affect rivals'
3 efficiency by diminishing their scale.
4 But I can't think as a lawyer of a way to design
5 a rule that doesn't have a chilling effect if we are
6 having to focus on what is minimum efficient scale and
7 what amount of a discount is permissible before you
8 usurp so much business that you prevent someone from
9 achieving minimum efficient scale. I think that is too
10 hard to administer.
11 MR. MEYER: What if you instead define the
12 defense, which is if the plaintiff is continuing to
13 operate profitably in the market for B, even if it is at
14 much lower volume than it had or market share than it
15 had, then the plaintiff's claim fails?
16 PROFESSOR LAMBERT: I would certainly have that
17 defense. I would say that if a plaintiff can match the
18 discount --
19 MR. MEYER: He may not have been able to match
20 the discount for all the customers to which it was
21 operating but still operating in the market for B is my
22 question.
23 PROFESSOR LAMBERT: Yes, I would give that
24 defense.
25 MR. KATTAN: That is exactly what happened in

1 the Ortho case.
2 PROFESSOR SIBLEY: I think people who know the
3 facts of LePage's better than I may tell me I'm all
4 wrong here.
5 As I recall, LePage's didn't claim it was going
6 out of business. It just had a lower market share and
7 it wasn't making as much money as it was before.
8 If this rule were applied to LePage's, I guess
9 it would have been over in favor of 3M. Let me
10 speculate as well. I don't know if this is true, and I
11 haven't thought about it before this second.
12 Even if we accept that a rival can only compete
13 profitably for a subset of consumers, maybe based on
14 some peculiar behavior scale of economies, something
15 like that, nonetheless, if the other firm, the one that
16 is not the rival in this case is pricing some other set
17 of consumers very high, it may be possible for the
18 rival, even though it can't serve the entire set of
19 consumers, to sort of skip around between subsets that
20 it does in fact serve and keep prices down that way.
21 PROFESSOR NALEBUFF: It seems to me that this
22 can still be a problem. And actually we saw a recent
23 case against Briggs and Stratton here in the lawn mower
24 industry, where some of the rivals were making some
25 money and others were actually losing so much that they

1 were exiting the business.

2 The view was that if the type of loyalty

3 payments had been different, those rivals would have

4 been at 20 percent of the market, they would have been

5 at 50 percent and the competition would have been much

6 more vigorous in that industry, that the customers would

7 have been able to have a whole collection of different

8 companies to buy from, that there would have been a lot

9 more innovation going on here.

10 So, if you are able to keep your rivals at 10

11 and 15 percent, they may choose not to invest in this

12 business, not to try and expand it. And I think there

13 can be tremendous harm in the long run here.

14 MR. DEGRABA: Anyone else?

15 Okay. Thank you.

16 I have time for one more before we break for

17 lunch. We will move to slide 8, which reads "In a

18 loyalty discount case, intent is relevant to proving

19 monopolization."

20 Do you agree or disagree? That comes from

21 LePage's, by the way.

22 MR. KATTAN: The question is intent to do what?

23 Every firm intends to take business away from its

24 rivals. When I discount, I'm hoping that by offering

25 the discount, I'm going to get more business for myself

1 and that my rivals are going to get less business.
2 That intent certainly shouldn't have any bearing
3 on the outcome of the case. You can assume that it did
4 in every case.
5 MR. MEYER: What if the intent were the converse
6 or the flip side of that, which is intent to achieve
7 some business justification, if you will -- I'm not
8 interested in what those might be -- evidence that there
9 wasn't a desire to exclude rivals or that that wasn't
10 the dominant driving factor in the business's behavior?
11 MR. KATTAN: I think that presents a more
12 complicated question. I think if you have a test that
13 focuses on objective factors, did I price below or above
14 cost, if I priced below cost, did that exclude
15 competitors, that you probably would not need to go
16 through things like that.
17 PROFESSOR NALEBUFF: I think this actually gets
18 to some of what Tom was asking about, which is is this
19 market ultimately monopolizeable, and I would extend
20 that to is there something else that you could achieve,
21 maybe not monopolize B but A.
22 It is harder to understand why firms would be
23 engaged in this type of exclusion if there was no
24 ultimate benefit for them. I also share the view that
25 trying to either look for evidence of intent one way or

1 the other is sufficiently manipulable or hideable that
2 I'm worried about playing that game.
3 You would have the advantage the first time it
4 is being done in that people aren't aware of it. So you
5 can have a lot of bad evidence.
6 And, of course, people say things that they
7 don't really mean in ways when they get into court that
8 can often not sound as good as sometimes they really did
9 mean it to.
10 MR. DEGRABA: Okay. Given that it is 12:00, I
11 will thank the panelists for all of their insight.
12 (Applause.)
13 MR. DEGRABA: We will reconvene at 1:30 after a
14 tasty lunch.
15 (Whereupon, at 12:00 p.m., the hearing was
16 recessed, to be reconvened at 1:30 p.m. this same day.)
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1 AFTERNOON SESSION (1:30 p.m.)
2 MR. MEYER: Let's get started.
3 Welcome to the second of today's sessions on
4 loyalty discounts. My name is David Meyer. I'm the
5 Deputy Assistant Attorney General at the Antitrust
6 Division. I will be monitoring this afternoon's session
7 with the help of Patrick DeGraba, who is at the Bureau
8 of Economics at the FTC.
9 The Department and the FTC are sponsoring
10 jointly this series of public hearings on single-firm
11 contracting to help advance the development of the law
12 concerning the treatment of unilateral conduct under the
13 antitrust laws.
14 Transcripts and other materials from prior
15 sessions are available on the DOJ and FTC Web sites, and
16 in due course, hopefully soon, the transcripts of
17 presentations from today's sessions will also be posted.
18 Our next hearing will be December 6th -- that's
19 next Wednesday -- addressing misleading and deceptive
20 conduct.
21 Today's session concerns the law and economics
22 of loyalty discounts.
23 Bundled discounts or rebates involving two or
24 more products have been a hot topic in antitrust forums
25 for some time, particularly since the LePage's decision

1 of several years ago.
2 In addition to bundled discounts, today's
3 panelists are also addressing single-product loyalty
4 discounts, sometimes referred to as first-unit
5 discounts, by which a seller provides a discount on all
6 units sold once certain targets are reached, not just
7 the discount on the incremental units sold above or
8 beyond the set targets.
9 Our morning panel offered many interesting
10 comments and observations about loyalty discounts of
11 both sorts, and we look forward to learning more from
12 this afternoon's panelists.
13 This afternoon's speakers are, starting with Tim
14 Muris, a George Mason University Foundation professor of
15 law. He is of counsel at O'Melveny & Myers and, as
16 perhaps all of you know, a former chairman of the FTC.
17 He also has the distinction of having headed
18 both the FTC's Bureau of Competition and the FTC's
19 Bureau of Consumer Protection.
20 PROFESSOR MURIS: Not at the same time.
21 MR. MEYER: That may be debatable.
22 Our second panelist is Daniel Crane, who is an
23 associate professor at law at the Yeshiva University
24 Benjamin N. Cardozo School of Law.
25 Our third panelist will be Janusz Ordover, who

1 is professor of economics at NYU and a former Deputy
2 Attorney General in the Antitrust Division.
3 And, finally, Will Tom, who is a partner at
4 Morgan, Lewis & Bockius and a former deputy director of
5 the FTC's Bureau of Competition.
6 More detailed bios are available out front. So
7 I will not bore you with all of the accomplishments of
8 all of these esteemed panelists.
9 The organization of the panel will be as
10 follows. Each of the four panelists will deliver a
11 presentation, approximately 15 to 20 minutes. We will
12 then take a short break.
13 When we return, we will start with each panelist
14 having an opportunity to take a few minutes to respond
15 or comment on the presentations made by the other
16 panelists, at which point after hopefully only 10 or 12
17 minutes, we will turn to a moderated discussion among
18 the panelists and with the panelists.
19 Unfortunately, I will not be able to take
20 comments or questions from the audience. We plan to end
21 around 4:00, but if the discussion is lively and
22 entertaining, we don't have any necessary hard and fast
23 end time.
24 The doors will be locked. So don't worry about
25 that. Before we start, I need to cover a few

1 housekeeping matters.
2 First, as a courtesy to everyone and given the
3 way the electronic system works here, I would ask you
4 all to turn off your cell phones and Blackberries or at
5 least turn them off of transmit so they don't cause a
6 problem with interference.
7 Second, as you may know, restrooms are all the
8 way across the hall past the elevators where you came in
9 this morning.
10 Third, and this is a required safety
11 announcement here at the FTC, if the building's alarms
12 go off, move calmly and quickly but act in the manner in
13 which you are instructed to. You will be exiting
14 through the main entrance if necessary. Presumably
15 there will be a lot of FTC folks who know what they are
16 doing. Just follow them.
17 With that, I would like to introduce and welcome
18 Tim Muris.
19 PROFESSOR MURIS: Thank you very much for the
20 very kind introduction.
21 In the long time since I left law school -- and
22 I think I look younger than my actual age -- I have had
23 a lot of jobs and six of them in the federal government.
24 With apologies to my many friends at the Antitrust
25 Division, four of them were at the FTC Commission, which

1 I guess makes me an FTC guy. But I have had a deep
2 fondness and respect for both agencies.
3 I'm going to talk today a lot about some
4 experimental economic work. Let me put it in an overall
5 framework.
6 I do want to disclose that I was retained by the
7 United States Telecom Association, the views in the
8 paper, and I will express views that are my own as well.
9 And this slide presents a framework that we all
10 know, I believe, which is the basic economic framework
11 about not just economics but about what a legal system
12 needs to do.
13 A legal system needs to be efficient, needs to
14 minimize some of the error costs and indirect costs, and
15 I believe we all know a lot about both of those. We all
16 know about type I, type II, and the direct costs makes
17 livings for lots of us.
18 The history of Section 2 is one that ought to
19 give us -- which I have written and many people have
20 written on -- one that ought to give us great pause. It
21 has largely been a history of mistakes, not exclusively.
22 As someone who launched the most aggressive use
23 of Section 2 of any enforcement head since the '70s, I
24 hope the pattern and history of mistakes doesn't
25 continue.

1 There obviously have been some good cases, I
2 believe, along the way. But as Hovenkamp says in the
3 second bullet, the scope and meaning of exclusionary
4 behavior remains, indeed, very poorly defined.
5 There's a few key cases in the bundling world
6 and in the broader world. Brooke Group clearly wanted
7 to minimize the type I error, recognized the high type I
8 costs, rejected the theoretical possibility of harm as a
9 sufficient basis for liability and focused on market
10 realities.
11 Probably the most important thing about Brooke
12 Group is Brooke Group is about having a bright-line test
13 that is administrable for judges, juries and parties.
14 I think my good friend Greg Warden phrased it
15 best, that it is a recognition that we don't want to
16 contemplate making mistakes in this area. I don't know
17 if I quoted Greg exactly, but I think I paraphrased in
18 the spirit.
19 Concord Boat is another important decision. It
20 doesn't address bundling but single-product market share
21 discounts in a manner that is consistent with the varied
22 cost approach of Brooke Group.
23 The discounts were above cost. They are
24 ordinary business practices often used in competitive
25 markets. They are not unlawful exclusive dealing.

1 The bottom line, it was not a Section 2
2 violation.
3 Then we come to LePage's. And whatever one
4 thinks of potential problems with bundled discounts, I
5 think it is hard to find supporters of the standardless
6 LePage's opinion.
7 It is an opinion that did not exercise caution,
8 a very poorly articulated theory of harm and an
9 incomplete record.
10 If you believe, which is usually a good thing to
11 do, to take the opinion at face value, the jury could
12 find a dominant firm liable under Section 2 based on the
13 possibility that bundled rebates, regardless of their
14 effect on consumer welfare, could exclude an equally
15 efficient competitor.
16 The point is that when you apply the
17 standard-free approach of LePage's to Section 2
18 liability, you are going to likely have high error costs
19 from false positives.
20 We know, and particularly because we live in a
21 world where bundles are everywhere, bundles can reduce
22 transaction costs in both the purchasing and selling
23 side of the market, they can serve as an alternative
24 traditional advertising, and they can be used, and a
25 very important part of the literature, they can be used

1 by companies to give retailers strong incentives to
2 promote and sell their products and services, which is
3 an efficient and important vertical control function.
4 As an example, one can think of bundling. The
5 consumers of telecom products and services demand
6 bundles. And we live in a world increasingly where the
7 competition of the future is between the traditional
8 so-called wireline companies and the cable companies
9 selling consumers bundled products, video, data, voice,
10 and now the cable companies are even offering wireless.
11 That's just one of -- we could go forever on
12 examples of bundling.
13 Now, the economic literature on exclusionary
14 bundling indeed shows that bundling can exclude
15 competitors. And from that it is possible that
16 anticompetitive harm could exist. They certainly don't
17 show that such harm is likely.
18 These models contain many restrictive
19 assumptions. They don't consider efficiencies from
20 bundling, and they have not been tested for robustness
21 or empirical application to the real world.
22 They simply don't show whether the potential for
23 anticompetitive harm outweighs the benefits from
24 bundling.
25 Now, there have been lots of suggested theories,

1 and one of the ones that would be a vast improvement
2 over LePage's but I still think has problems is the idea
3 of excluding a hypothetically equally efficient
4 competitor.
5 This in itself focuses by itself -- I believe
6 Professor Hovenkamp has supported this but now in a much
7 narrower version than he originally did.
8 By itself this focuses on harm to competitors,
9 not competition, and the bundled discount would exclude
10 -- using this test, would exclude a bundled discount
11 that could help consumers.
12 My basic problem with the test can be summarized
13 in one simple sentence, which is all else equal, how can
14 a firm that offers you less of what you want be equally
15 efficient with a firm that offers you more?
16 And I think the government in its 3M brief had a
17 sentence alluding to the fact that, indeed, the whole
18 concept of equally efficient might be a difficult
19 proposition here.
20 This is an example. I won't go through the
21 arithmetic because I do want to get to the experimental
22 economics. This is an example that Professor Hovenkamp
23 uses, and it's an example clearly where bundling
24 increases consumer welfare.
25 Yet, you can see that the alleged equally

1 efficient competitor is excluded.

2 Let me move to what I in my ways believe is a
3 significant contribution to moving the ball forward on
4 the issue of bundled discounts, and that is work that
5 was done by Vernon Smith and his colleagues at the
6 Interdisciplinary Center for Economic Sciences at George
7 Mason, where I teach, so-called ICES.

8 Vernon is one of the fathers of experimental
9 economics, and for that work he received the 2002 Nobel
10 Prize in economics.

11 Experimental economics uses laboratory subjects
12 to test the validity of economic theories.

13 One of the many good things about experimental
14 economics is in numerous settings, experimental
15 economics has been shown to be consistent with the way
16 the real world works.

17 One of the most interesting things --
18 experimental economics is sometimes criticized because
19 they use college students. I have watched the
20 economists compete with the students. And the college
21 students have nothing in mind but making money in these
22 experiments, and the economists are often trying to
23 think of some theory. And the college students
24 invariably kill them.

25 And I participated in these experiments myself.

1 My colleague at George Mason, Bruce Kobiashi, can
2 remember going down many a time for beer money, to pick
3 up a little money. But you had to be good at the
4 experiments.
5 What ICES did was they conducted an experimental
6 evaluation of various theories of anticompetitive
7 bundling using a baseline case and then variations on
8 the case.
9 The variations included changes in the
10 correlation of reservation values. I don't know if
11 Professor Nalebuff and Sidley talked about that this
12 morning, but the relationship of the reservation values
13 is extremely important in this literature, the existence
14 of efficiencies from bundling and the introduction of a
15 fringe competitor to the monopolist.
16 What you have is an A market with a monopolist.
17 100 percent of the literature assumes 100 percent that
18 also sells in the B market. And in the experiments, the
19 B market was served by up to three sellers of only B.
20 The baseline experiment tested cases in which
21 bundling by the monopolist was first prohibited and then
22 permitted. There are lots of details about this that
23 are available in the paper.
24 The baseline results showed that despite no
25 efficiencies and despite a setting under which you would

1 think that bundling could be problematic, consumer
2 welfare still increased, although it wasn't
3 statistically significant.
4 And then when you added efficiencies, that is,
5 transaction costs, savings or the assumption of perfect
6 correlation and demand, the welfare-increasing effects
7 of bundling rose.
8 Here are again the details that are in the
9 paper, and the slides are available, and obviously we
10 have given you a set of the slides.
11 What was measured was consumer surplus, total
12 surplus and the number of competitors. And then the
13 variations were the transaction cost savings, the
14 negative correlation.
15 The Stigler paper on black booking, which was
16 one of the first papers here, had as opposed to perfect
17 positive correlation, perfect negative correlation,
18 which was a situation that allowed price
19 discriminations.
20 Under each of these, sometimes it was
21 statistically significant and sometimes it wasn't, but
22 there were not welfare losses. And only when bundling
23 was efficient did statistically significant exclusion
24 occur, which is interesting.
25 Now, what happened is after these -- I consulted

1 throughout this experimental process. We were hoping
2 that what we would find is under these very simple
3 conditions here, you have anticompetitive effects of
4 bundling which these models had predicted, and then we
5 would tweak them some and see what happened.
6 Since we couldn't find anticompetitive bundling
7 effects, what we decided to do was modify the demand
8 conditions to make exclusionary bundling more
9 profitable.
10 The reservation value for the B good was raised
11 to greatly exceed the reservation value for the A good
12 for a lot of consumers, which meant there was more to
13 get out there.
14 Under the modified demand conditions, the
15 bundled discounts can exclude competitors in the B
16 market. And, indeed, welfare did fall, but it was very
17 little and it wasn't statistically significant.
18 Look at the conditions that had to occur. There
19 were extreme assumptions regarding the demand in the B
20 market. There was perfect positive correlation between
21 the A and B market demand.
22 There was no fringe seller in the market, and
23 there were entry and exit frictions in the sense that if
24 you entered, you had to stay for some periods, and if
25 you exited, you had to stay out for some periods.

1 And here are the results. You can see there was
2 a big drop in the number of competitors. And there was
3 actually a drop in surplus, both consumer and total, but
4 very small and not statistically significant.
5 Now, then the results of the experiments were
6 changed to add -- one of the nice things about
7 experiments, you can hold a lot equal and make a lot of
8 variations, to add a fringe seller, with the fringe
9 seller having a small fraction of the capacity of the
10 market.
11 With the fringe seller, the total surplus
12 increased, and also they tested the effects of removing
13 those entry and exit frictions that I talked about.
14 Those alone reversed the negative welfare results that
15 were shown in table 2.
16 And here in table 3 are the results, showing the
17 various effects of what I just described.
18 Let me briefly say what a lot of this means, and
19 I do hope to do this under my 20 minutes.
20 We have the various tests. The hypothetically
21 equally efficient competitor test, for reasons I stated
22 before, it is overinclusive, and it would condemn
23 bundled discounts that increased welfare.
24 The de facto tying test requires knowledge of
25 the hypothetical monopoly price in the absence of

1 bundling, which is a price generally not easily
2 ascertained, to say the least.
3 If deviations from perfect competition in the B
4 market or other alternatives are considered, this
5 further complicates the test.
6 I don't know what Professor Sidley talked about
7 this morning, but in the second paper he did, he showed
8 that his results of anticompetitiveness depended on
9 perfect competition in the B market.
10 And, of course, perfect competition in the B
11 market is not -- perfect competition anywhere is not
12 something we find much of in the real world.
13 Based on the experiments, the conditions under
14 which this de facto tying will emerge are very limited.
15 And, of course, we already have rules about tying.
16 I think that the most appropriate test would be
17 a modified Brooke Group test, which would be based on
18 the bundled price exceeding the bundled cost. It would
19 minimize the cost of false positives, and it would be
20 administrable.
21 And in that sense, in the absence of evidence
22 that the cost of false negatives from anticompetitive
23 exclusionary bundling is large, I submit that we should
24 use the modified Brooke test.
25 So just a few points in conclusion.

1 I believe and I think that Barry Wright's case,
2 as Professor Crane and others have stated, Professor
3 Lambert, who was here this morning -- clearly the
4 federal courts have ruled on single-product pricing
5 behavior.
6 But that is not true for bundled discounts.
7 LePage's is standard free and it has spread beyond the
8 Third Circuit. Read Pease Health, a Ninth Circuit
9 District Court case which is discussed in the paper.
10 Given the history of Section 2 and given that we
11 are dealing with price application of Section 2 to any
12 exclusionary conduct, particularly this one, we should
13 follow a cautious approach that is consistent with that
14 applied to the single-product pricing in order to
15 minimize the sum of error and direct costs.
16 And the courts and those subject to potential
17 liability would benefit from guidance that reduces the
18 uncertainty that LePage's has created and stems the
19 general application of the Third Circuit's flawed
20 approach.
21 I'm hoping that these hearings, among many other
22 good things they will do, will accomplish that result.
23 Thank you very much.
24 (Applause.)
25 MR. MEYER: Our next speaker is Daniel Crane,

1 who, as I said, is an associate professor of law at the
2 Cordozo School of Law. He is also counsel at Paul,
3 Weiss, Rifkind, Wharton & Garrison.
4 PROFESSOR CRANE: It is my pleasure to be here
5 today. I'm going to speak primarily about bundled
6 discounts, the LePage's issue, and I'm afraid I will
7 repeat some of what was said this morning, but hopefully
8 to good effect.
9 I should disclose I am been involved and
10 continue to be involved in some cases as a lawyer in
11 which bundled discounts are at issue, though, of course,
12 the views I present today are my own.
13 I will not use any slides. We can just listen,
14 I hope.
15 At the outset, let me stress that the rule that
16 I'm going to defend as a safe harbor, the Ortho test, or
17 perhaps the Ortho test with some modification, is not a
18 rule that is perfect.
19 It is not a rule that will achieve a state of
20 affairs where all discounts that are harmful to
21 consumers will be said to be illegal and all that are
22 pro-competitive will be lawful.
23 But what I think is important as a lawyer, of
24 course, now as an economist, is to articulate
25 practicable, workable rules for the courts. This is

1 particularly important for private litigation.
2 At the end of my remarks, I will talk about how
3 I would welcome a perhaps different approach in
4 injunctive cases brought by the government than in
5 private litigation. Because of some features of private
6 litigation, I am quite confident that the LePage's test
7 is doing far more harm than good.
8 Let me sort of set forth four background
9 conditions against which I will defend the Ortho test as
10 a safe harbor in litigation.
11 The first background condition which has been
12 addressed already today is that bundled discounting is
13 pervasive and has many pro-competitive or competitively
14 neutral reasons.
15 When a practice is widespread and usually
16 competitively neutral or pro-competitive, courts should
17 be particularly concerned about condemning instances of
18 that conduct without very strong proof of
19 anticompetitive consequences because of the dangers of
20 false positives.
21 Just to give an example about how widespread and
22 pervasive bundled discounting is, when I was working on
23 my article for the Emory Law Journal about bundled
24 discounting, I looked at my e-mail, and lo and behold, I
25 got an e-mail from the ABA antitrust section advertising

1 "Market Power Handbook" and "Econometrics," two separate
2 books, for a package price which is a 12 percent bundled
3 discount off of the retail price of the two
4 individually.
5 I ran into Dan Rubinfeld a short while later,
6 who is the editor of one of the books, and I promptly
7 served on him a complaint for monopolizing the economics
8 and antitrust literature market.
9 Of course, bundled discounting happens in all
10 sorts of places where there can be no suspicion of
11 anticompetitive conduct.
12 That doesn't mean that cases like that will be
13 litigated, but what it shows you is when you have a
14 pervasive practice, there are often likely to be good
15 explanations for it, which should make us particularly
16 reluctant to condemn instances where there might be
17 anticompetitive consequences without very strong reasons
18 to do so.
19 A second background condition is that bundled
20 discounts in commercial contexts are often driven by
21 buyers rather than sellers. Significantly, many of the
22 recent bundled discount cases to be litigated did not
23 involve sales to end consumers but to retailers or
24 manufacturers acquiring components or other large
25 oligopsony or monopsony buyers.

1 Large diversified buyers often leverage their
2 buying power across multiple product lines to exact a
3 bundled discount from the manufacturer. And, of course,
4 these buyers have a strong incentive not to demand
5 discounts when doing so would weaken competition in the
6 markets that supply them.
7 So my own view is that bundled discounting,
8 often driven by buyers in these cases, the incentives of
9 the buyers themselves are much better at controlling
10 competition than litigation is.
11 This morning Barry Nalebuff said that oftentimes
12 in bundled discounting cases, one of the problems with
13 bundled discounts is that they sort of conceal what the
14 real price is, it is hard to know what the real price
15 is, it can cost up to $10,000 for a buyer to really
16 compare apples to apples unbundled versus bundled.
17 When we are talking about buyers like Wal-Mart
18 or GPOs and the medical devices cases, AMD, Intel,
19 Broadcomm, Qualcomm, Information Resources versus A.C.
20 Nielsen, many of these litigated cases involve very,
21 very large sophisticated buyers.
22 So even if it is true that sometimes comparing
23 apples to apples is difficult, if you look at the cases
24 litigated today, it seems to me that is simply not an
25 objection.

1 A third background condition is that I believe
2 that courts need rules and not merely open-ended
3 standards, particularly in sensitive areas of price
4 competition and Section 2.
5 I have a forthcoming article in the Washington
6 and Lee Law Review about the rules and standards debate
7 as applied to antitrust law where I argue in favor of
8 bright-line rules to immunize defendants from lawsuits
9 in cases involving particularly private litigation and
10 unilateral practices.
11 Committing economic policy to juries in cases
12 like LePage's is a really miserable way to run a legal
13 system.
14 A fourth and related background condition is
15 that a growing literature -- including my co-panelist,
16 Janusz Ordover, has written in this area -- shows that
17 firms can strategically misuse antitrust law to prevent
18 pro-competitive behavior by their rivals.
19 As I will discuss in a few minutes, I believe
20 that many of the recent bundled discounting cases
21 involve frustrated competitors seeking to deny
22 commercial advantage to a more diversified rival, not
23 firms that are in any real danger of being excluded from
24 the market.
25 Well, with these background conditions as

1 considerations, let me say a word about why it is not
2 sufficient to analogize bundled discounting to tying or
3 exclusive dealing, as some cases like LePage's have
4 suggested.
5 In a tying case the consumer is required to take
6 the tied product if he wants the tying product as well.
7 In a bundled discount case, the consumer always has the
8 choice to buy simply the tying product.
9 Of course, it is possible that the discount is
10 so large that it would be economically irrational for
11 the consumer who wants both products to buy just the
12 tying product and then purchase the tied product
13 separately from the plaintiff or a smaller, less
14 diversified firm.
15 But that would only be the case if the plaintiff
16 was unable to offer a discount that would make the
17 consumer indifferent on whether it accepted the
18 defendant's package discount or bought the two items a
19 la carte. Of course, that's a question that tying
20 analysis lacks the tools to answer.
21 Similarly, an exclusive dealing analysis focuses
22 on whether the defendant's contractual practices
23 foreclose a substantial share of the relevant market to
24 rivals.
25 But foreclosure is, again, an empty concept

1 unless it means that rivals cannot compete for the
2 business.
3 To put it another way, if a rival would be able
4 to profitably match the defendant's bundled discount,
5 what we have is ordinary price competition and not
6 foreclosure.
7 The problem with using exclusive dealing
8 analysis to assess bundled discounts is that exclusive
9 dealing analysis begins with the assumption that
10 whatever contracts are covered by the relevant contracts
11 are foreclosed to rivals, a fact which is not even in
12 evidence yet in bundled discounting cases.
13 So either a tying analogy or a bundled discount
14 analysis, without first looking at sort of economics of
15 the discount, is really putting the cart before the
16 horse.
17 Let me now turn to the rule for bundled
18 discounts that I will defend as a safe harbor. Janusz
19 tells me he created this on the back of a napkin. So we
20 will leave it to him to give you a history of this.
21 The rule traces back at least to the Ortho
22 decision. It was adopted in some litigated cases,
23 including Information Resources versus Dun & Bradstreet,
24 a Southern District of New York case, and I believe is
25 reflected in Professor Hovenkamp's 2006 supplement to

1 the antitrust treatise.
2 A plaintiff challenging a seller's bundled
3 discounts as predatory must show as a minimum
4 requirement that the bundled discounts resulted in at
5 least one product in the package being sold at less than
6 cost after reallocation of the discounts on other
7 products in the package to the predatory product.
8 Another way of saying this is that the bundled
9 discount is not unlawful unless the effective price of
10 the product in the competitive market is below cost,
11 taking into account the discounts on noncompetitive
12 products that the consumer would forego by buying the
13 two products individually instead of in the package.
14 In my Emory Law Journal article, I propose a
15 number of additional showings the plaintiff would have
16 to make. I won't discuss those here, in the interest of
17 time.
18 I want to defend the sort of core concept
19 underlying this analysis which is an analogy of two
20 predatory pricing, although with some modifications for
21 bundled discounts, which is what I think the LePage's
22 court says should not be done, we should not analogize
23 to predatory pricing. I argue we should, although it
24 may take some qualification of the rules.
25 The basic argument is based on the Brooke Group

1 standard itself. Under Brooke Group, a single-product
2 discount is per se lawful unless it results in pricing
3 below an appropriate measure of cost.
4 I will put aside what the appropriate measure of
5 cost should be and assume we know what it is in a
6 particular circuit. Let's call it X.
7 What that means is that a defendant would have
8 an unqualified right to offer a discount on the good Y
9 so long as the price continued to exceed X.
10 Now, suppose the defendant offers a bundled
11 discount on goods Y and Z and that the plaintiff sells
12 only Y. The plaintiff cannot offer a discount on Z.
13 But by reducing the price of Y, it can make up for the
14 discounts that consumers would forego by continuing to
15 buy the goods unbundled.
16 So long as the effective price for the
17 single-product firm is not below X, it is no more
18 disadvantaged than if the defendant had offered the same
19 above-cost prices through a single-product discount on
20 Y.
21 Since a single-product discount resulting in a
22 price above X would be per se lawful, a multiproduct
23 discount resulting in effective price above X should
24 also be lawful per se.
25 Let me sort of answer some arguments against

1 this logic that I have seen discussed in economics
2 literature, actually moreover in litigation briefs,
3 which are probably not a good source of economic
4 reasoning, but nonetheless, let me discuss a few things.
5 One sort of very common argument is that where a
6 single-product predation is expensive and risky because
7 it involves sustaining losses for an indefinite period
8 of time to drive out or discipline rivals, the
9 multiproduct predator sustains no losses from the
10 bundled discount because it can cross-subsidize the
11 discount in the competitive market with discounts off
12 the prices in the monopoly product.
13 Of course, the diversified firm that uses a
14 multiproduct discount to exclude rivals is also
15 sacrificing profits with the hopes of long-term
16 recoupment.
17 A discount of one dollar off the monopoly
18 product for the purpose of subsidizing the campaign of
19 exclusion in the competitive product is economically
20 identical to a single-product firm taking a dollar out
21 of a bank and subsidizing single-product predation.
22 Unless there is rate regulation over the
23 products and the bundled discount is somehow being used
24 to fool rate regulators, this cross-subsidization story
25 doesn't really hold up.

1 This morning Professor Nalebuff argued that
2 loyalty discounts can create noncost predation by
3 threatening to inflate the monopoly price. In his
4 model, the monopolist says I'm going to jack up the
5 monopoly price of the monopoly product unless you take
6 my bundled discount.
7 Of course, as Professor Nalebuff recognized,
8 this only works if the threat to jack up the monopoly
9 price is credible.
10 Of course, the reason that the defendant has not
11 charged a price higher than the current price, the
12 current monopoly price is that any further price
13 increase would by definition be unprofitable because
14 there would be substitution to other products.
15 So the buyer has its own very credible threat,
16 which is if you jack up the price even further, I will
17 substitute to other products. By definition, the
18 profit-maximizing price being charged already is one
19 which will become less profitable to the seller if he
20 jacks up his price even further.
21 Although I'm not saying it could not happen, it
22 is certainly the case that the threat I will raise my
23 price where the defendant is already charging the
24 profit-maximizing price gives rise to another threat by
25 the buyer, which is in that case I will substitute to

1 something else.
2 A second argument that is sometimes made is that
3 bundled discounts, unlike single-product below-cost
4 pricing, can go on indefinitely. If that is true, it is
5 because there is no sacrifice in profits and no need of
6 future recoupment.
7 That suggests to me that the reason that the
8 diversified firm is able to offer the bundled discount
9 indefinitely is that there are legitimate business
10 reasons for doing so that do not depend on the exclusion
11 of competitors.
12 Of course, competitors can be excluded from the
13 market by any number of strategies, but those should
14 typically not be of concern under the antitrust laws if
15 they reflect reasons that have legitimate business
16 justifications. That is to say, business justifications
17 that make the practice profitable, even assuming
18 continued competition.
19 A third and final criticism I will just touch on
20 briefly is sort of really a criticism of the equally
21 efficient competitor hypothesis in the Ortho case.
22 Under the Ortho formulation, the plaintiff would
23 have to show that it is as efficient a producer as the
24 defendant in at least the competitive product.
25 This has been criticized on the grounds that

1 what if the plaintiff is a new entrant, it is trying to
2 achieve economies of scale, it is the defendant's very
3 practices that prevent it from reaching economies of
4 scale, so how can a defendant say that he should have
5 been equally efficient in order to sue.
6 For present purposes, I don't want to take a
7 position on this, although I do think the equally
8 efficient competitor hypothesis is probably correct. I
9 would be happy with a test that simply required some
10 price-revenue comparison, because that would at least,
11 different than LePage's, force the focus back on to
12 whether the plaintiff really had options or simply
13 whether the defendant's discounts were exclusionary in
14 the market.
15 I think even that would be a substantial
16 improvement on sort of the open-ended standardless
17 approach of the LePage's case.
18 Let me conclude my remarks, then, by arguing for
19 the need for bright-line rules in unilateral
20 exclusionary practices cases, particularly in private
21 actions for damages.
22 As I noted at the outset, it is not difficult
23 for law professors and lawyers and economists to create
24 sort of armchair assumptions about markets that show
25 exclusionary practices in various forms.

1 Nonetheless, adoption of bright-line rules is
2 necessary to prevent strategic misuse of antitrust law
3 by rivals.
4 Many of the cases brought in recent years are
5 not cases brought by very small firms that are on the
6 margins of the market. These are cases brought by very
7 dominant, large firms with very substantial market
8 shares, with a good bit of profitability and a recent
9 history of success in the market.
10 One has to ask if the exclusion story doesn't
11 seem to be strong on its face, what's really going on
12 here.
13 The answer may very well be, although I can't
14 prove what any individual plaintiff intends, that there
15 is simply an effort being made to prevent more
16 diversified firms from using their diversification as a
17 competitive tool.
18 Now, it is one thing to say that we will commit
19 these issues to juries, as LePage's did, but of course
20 jury trial is extremely rare.
21 The statistics from the U.S. courts
22 administrative offices show that there are approximately
23 nine civil antitrust cases a year out of about 860 that
24 are terminated. So less than 1 percent of all private
25 antitrust cases will end up before a jury.

1 LePage's is the exceedingly rare case. What
2 happens is that all the cases either are dismissed on
3 summary judgment or a motion to dismiss or they have to
4 settle, they have to settle because defendants simply
5 cannot take the risk of going to trial.
6 So what happens, then, is unless the courts are
7 given good, solid, antitrust rules that can serve as
8 screening devices on a motion for summary judgment or a
9 motion to dismiss, the only question becomes how big is
10 the price tag, the settlement that the defendant has to
11 pay to avoid the trial.
12 I think this is sort of a culture that LePage's
13 has encouraged. Courts often interpret the LePage's
14 standard as really a commitment of these issues to
15 juries, although we haven't had lots of jury trials. In
16 some cases it is because defendants have had to pay to
17 get out of them.
18 Let me conclude by saying though I think rules
19 are necessary as screening devices for private
20 litigation, I'm actually more sympathetic to
21 experimentation by the government with different
22 theories of exclusionary conduct.
23 I think one of the unfortunate things that has
24 happened in unilateral cases is that these same rules
25 that have been designed to protect against abusive

1 litigation by private plaintiffs have been applied
2 wholesale to government cases, and I think a good
3 example of this is the U.S. versus American Airlines
4 predatory pricing case, where the court simply used sort
5 of off-the-rack rules that were really not sort of
6 designed to prevent against abusive private litigation
7 but didn't take into account the differences that occur
8 when a government sues.
9 So while most of my comments have been very
10 skeptical about bundled discounting cases and supportive
11 of strong rules to weed out these cases early on in the
12 litigation, except the most meritorious cases, I do
13 think the government, whether FTC or DOJ, as plaintiff
14 should be given more latitude.
15 Thank you.
16 (Applause.)
17 MR. MEYER: Our next speaker is Janusz Ordover,
18 who needs no introduction. He is professor of economics
19 at NYU, as I mentioned, former deputy Assistant Attorney
20 General of the Antitrust Division and a frequent
21 participant in antitrust debates of all sorts.
22 PROFESSOR ORDOVER: Thank you very much, David,
23 for the kind words. As I say, I always need an
24 introduction just to keep my name in front of the
25 public, like Coca-Cola and Pepsi or Marlboros, maybe.

1 My topic today is loyalty rebates. I frequently
2 do something which is inappropriate which is create way
3 too many slides. I have not deviated from my strategy
4 here either.
5 What I do have is way too many slides. Plus, I
6 have also asked the organizers to post two of my papers
7 which deal with the issue of loyalty rebates and which
8 are in order to show the economists' schizophrenia are
9 quite adversarial to each other.
10 I mean that one tries to demonstrate
11 circumstances in which loyalty rebates, back to first
12 unit type discounts, are potentially anticompetitive,
13 and we actually demonstrate how they can be so. And the
14 other paper in which the same kind of loyalty rebates
15 turn out to be powerfully procompetitive.
16 I have spanned the universe of possible
17 outcomes. The big challenge is to try to figure out how
18 to marry these two approaches. It is at this marriage
19 level that the huge challenges to economic modeling are
20 likely to come about. I will come back to these papers,
21 of course, in a very short minute.
22 There is no point to running you through the
23 usual introductions, as you have been here this morning,
24 many of you.
25 We also already talked about what the loyalty

1 rebates entail.
2 The main point that I wanted to make, other than
3 the fact that we don't know yet enough about their
4 economic effects in the wide variety of settings, the
5 point that I really think is worthwhile keeping in mind
6 is we both need more empirics, more technical research,
7 and also I think a lot of bright-line rules, because I
8 believe strongly that absent bright-line rules, we are
9 going to create mischief on both sides.
10 Remember, there are two types of errors. We
11 always forget that.
12 The point that is I think worthwhile is the
13 interesting aspect of these loyalty rebates that really
14 comes to play as the driver behind the variety of
15 outcomes from models of these settings. And really the
16 loyalty rebates create complex links in the product
17 space between the supplier and the consumer.
18 These links could be across volume, across time
19 or across products. Because of these links, because of
20 these externalities that come about as a result of the
21 loyalty rebates or bundled rebates, different
22 manifestations, the typical analyses that we have are
23 difficult to carry out.
24 Normally we do not think very easily in terms of
25 mathematical modeling or empirics in which there are

1 these kind of versions of almost network-like effects.
2 In this case, the network-like effects are much
3 more concentrated as between the pair of transactors and
4 spilling into the outside world in which the third
5 parties are being affected one way or the other by the
6 internal contractual arrangement between the seller and
7 the buyer.
8 It is quite true, as I have seen in litigation
9 myself, that often it is the actual buyer that is
10 requiring or asking for or demanding the creation of
11 those kinds of links.
12 Of course, I missed here Professor Einer
13 Elhauge, who would have talked about these kinds of
14 links extensively in the context of GPO purchasing
15 practices, which are being litigated as we speak.
16 I also have to fess up that I have an interest
17 in the outcome of these litigations.
18 In any case, it is the nature of these links
19 that creates complexity for economic modeling of the
20 sort that I think is illustrated in some kind of
21 examples that have been put forth.
22 This is the Hovenkamp example that Tim Muris
23 already took apart. So I don't want to waste my time on
24 that because this example actually proves nothing. It
25 proves nothing because it is not embedded in any known

1 economic model of anything.
2 I second Professor Muris's point that learning
3 from stripped down examples is a dangerous thing to do,
4 that we really have to rely on the complete and deep
5 understanding of the circumstances in which the practice
6 takes place and understand fully and well all the
7 economic forces that act upon the practice, the
8 transacting parties as well as on the third parties and,
9 in particular, on consumers ultimately, ultimately
10 consumers.
11 A simple example that people have often used
12 showing that it excludes an equally efficient competitor
13 is, okay, so what, is there any problem with exclusion
14 of this equally efficient competitor, assuming -- again,
15 I agree here with the previous speaker -- that what it
16 means to be an equally efficient competitor is subject
17 to debate.
18 Indeed, some of you may be as old as I am.
19 Although -- do I look younger or older than you? We
20 will debate that later.
21 What I'm trying to say is that when the issue of
22 that kind of an equally efficient competitor came out
23 way back in the Turner treatise days, in the context of
24 multiproduct firms predating against single-product
25 firms, Professor Areta said -- I think it in a letter to

1 Will Dommel commenting on the Ordover paper efforts --
2 saying there is absolutely no reason to give a
3 multiproduct firm a leg up in competition against the
4 single-product firms because there is no reason why
5 should we take into account these deep potential links
6 on the demand side or on the supply side or the cost
7 side and the cross-elastic side in terms of lowering the
8 benchmark price against which the rival ought to
9 compete.
10 Now, that was Professor Areta probably now 20 --
11 maybe 18, 19 years ago. I think our thinking has deeply
12 changed.
13 We do understand a lot of complex relationships
14 in terms of the efficiencies that are involved, whether
15 it is on the cost side, gains from a multiproduct
16 production, whether it is on the savings side, the
17 bundling effects from offering a wide variety of
18 products in order to minimize efficiency, inefficiency
19 of transacting and so on, coupled again with the Barry
20 Nalebuff point, which is now very fashionable at MIT and
21 at Harvard, when economists talk about so-called
22 shrouding. You know what the hell it means, is it some
23 kind of religious ceremony? No.
24 It involves marketing practices precisely of the
25 sort that make it very hard for a consumer to figure out

1 what the price is. Is shrouding good or is it bad? We
2 don't know. It depends on the model and the facts.
3 The facts are the driver of our analysis when
4 properly slotted into some well-understood economic
5 theory.
6 So what I want to do is to give you a quick run
7 through the two papers with Greg, who threatened to be
8 here but I don't see him, thank God. Otherwise, he
9 would take me to task for misrepresenting our research.
10 The research in fact can be misrepresented or
11 represented in a variety of ways. It goes back to
12 something that happened to me and Steve Salaw in
13 connection with our paper on vertical issues where Steve
14 viewed that as a theorem, proof that vertical
15 relationships could be anticompetitive. I viewed it as
16 a proof that circumstances under which vertical
17 relationships could be anticompetitive is actually
18 difficult to implement.
19 We had the same paper, and the two authors
20 agreed to stay neutral on the subject. The same paper
21 can been seen from a variety of perspectives.
22 What it is that Greg Schaefer and I have tried
23 to do, and we are hard at work at probably a few more
24 versions of these kind of analyses, is to construct
25 economic scenarios which I think are plausible as

1 opposed to two-by-two examples that do not reside in any
2 well known market setting -- other than Ortho -- in
3 which these types of loyalty rebates which is what I
4 want to talk about or back to first-unit discounts do
5 emerge as equilibrium offers.
6 Remember that much of the problems we had with
7 examples is it is never tested whether or not what is
8 happening in the example is an equilibrium or not. If
9 it is, what is the gain that underlies the example.
10 Greg and I have specified two sets of cases in
11 which these kind of loyalty rebates as equilibrium
12 offers. One is the one in which -- the first one is the
13 one in which exclusionary loyalty rebate does come
14 about.
15 This is a model, a very stripped down model.
16 Let me take you quickly through it. The papers are
17 posted. Probably incomprehensible for the lawyers in
18 the audience, but maybe not.
19 The setting is straightforward. It is stripped
20 down. We have two competitors, one of which is, quote,
21 unquote, "dominant" in the following simple sense, that
22 is, it is capable of producing output for the whole
23 market. Whereas, the other, the rival, the smaller
24 competitor, the entrant can only produce one unit of
25 output.

1 From a social welfare standpoint, ideally we
2 would like one unit to be sold by each. And the reason
3 for that is there a heterogeneity of preferences. The
4 consumers who would like to buy in the marketplace, they
5 like the incumbent's product and some other people like
6 the challenger's product.
7 In an equilibrium, we would like to see people
8 being optimally served, which takes me back to the
9 question of what do I mean by an equally efficient
10 competitor.
11 In the model that we have constructed, each firm
12 has the same marginal cost of production, but their
13 products are not equal. So they are equally efficient
14 on the cost side, but they have heterogeneous offerings,
15 which is an environment where economics is not entirely
16 clear, what do we mean by an equally efficient
17 competitor.
18 When I am selling A and you are selling B, and
19 they are not perfect substitutes for each other, it is a
20 bit of a challenge to give a crisp and clear definition.
21 In that model, there are some assumptions that
22 actually have to be made in order to create a
23 circumstance whereby an equilibrium exclusionary offer
24 arises, i.e., an offer that denies consumers the ability
25 to purchase the product they would like to get.

1 Again, this goes back to my misspent youth with
2 Shaffer and Salaw. You can argue amongst yourselves --
3 I will be happy to chip in later on -- whether the
4 conditions that we have specified are necessary, are
5 they sufficient and more or less are they realistic,
6 because the usefulness of the model stems, at least in
7 my view, from modeling circumstances that are not so off
8 the wall as to give no guidance to anything. But the
9 conditions we have specified I think are of interest.
10 For example, in the paper we have the assumption
11 that the incumbent can supply all of the market but the
12 entrant can supply only at most one unit. Whether it is
13 one unit versus two or two versus five is not
14 necessarily an issue. But it is the foundation of the
15 differential that exists.
16 The second assumption that I think is important
17 is that the model has two periods involved. Remember I
18 told you about the links that are being created through
19 these exclusionary, potentially exclusionary offers.
20 Here the link is intertemporal. That is,
21 through time. And it is that fact in the model that
22 actually is another of the key drivers.
23 In period two, the buyer becomes locked in to
24 the seller or the sellers from whom it purchased in
25 period one.

1 What does that mean? In a normal economic
2 model, it would mean people would beat their brains out
3 to get the second period profits and would give them all
4 up in the first period.
5 Remember the Supreme Court profound economic
6 analysis in ITS v. Kodak on that subject.
7 So, no restriction on feasible sale of
8 contracting. However, the entrant faces a financing
9 constraint, a cap on how much it can borrow against its
10 potential period two lock-in gains in period one.
11 Now the question comes in whether you are the
12 believer in the old fashioned finance literature or more
13 inclined to the new old fashioned financial literature
14 in which the financing constraints are in fact a fact of
15 life for a variety of reasons. And I refer you to
16 Turro's new brilliant finance textbook.
17 The second aspect of this whole thing is that
18 the entrant cannot commit to its second period price in
19 period one. How realistic is it? I don't know. It
20 depends on the setting.
21 So there are two key assumptions or three that
22 limit the capacity of the entrant. The inability to pay
23 for all of the first period battle, either with borrowed
24 money or with the second period money, whether these are
25 realistic, that depends on the particular circumstance.

1 And I believe that there are settings like that in which
2 these conditions are likely to be satisfied.
3 In such an equilibrium, such as we do have
4 equilibria in which the entrant gets no sales, the
5 incumbent makes the sales despite the fact that he is
6 going after or she is going after or it is going after
7 the marginal unit which is less valued to consumers
8 being supplied by the incumbent firm versus the
9 challenger.
10 Now, again, this goes against the grain of the
11 Chicago -- perfectly on time -- against the Chicago view
12 of life, which is why would anybody pay to gain sales
13 against somebody who can offer those same sales more
14 efficiently?
15 And the answer is well, there are these
16 intertemporal links. These kind of relationships do
17 change the analytics. Moreover, and here is why these
18 constraints that we have talked about are key.
19 Moreover, how much you have to pay in order to
20 steal or to grab or to sell that second unit is clearly
21 tied to how much the rival, the entrant can pay to keep
22 it for itself.
23 If the price is low because the rival can only
24 offer the buyer a penny but you would be happy to offer
25 two pennies to something that would lead you to three

1 cents gain tomorrow, you are going to do that.
2 The Chicago view is again somewhat too
3 simplistic in terms of the underlying economics. I'm
4 not saying as a matter of empirics it is flawed, but as
5 a matter of underlying economics, we all know we are not
6 Chicagoans anymore. I believe that's the right place to
7 be, out of Chicago, leaving Chicago yet again.
8 It is a slide. To switch direction completely,
9 Shaffer and I with his graduate students have come up
10 with another model in which in fact the efficiency of
11 the first-unit discount rebate comes out in a very
12 stripped down equilibrium as well.
13 In that model, there is no competition. There
14 is only a supplier that has a monopoly, and he is facing
15 two states of the world of which one is the high demand
16 and the other one is the low demand.
17 As you all know, obviously, from your
18 microeconomics textbooks, in such a world the seller
19 would like to create incentive to sell as much as
20 possible in the high-demand state.
21 But the buyer may not want to reveal whether it
22 is a high-demand state or not. You have this asymmetry
23 of information.
24 If there is an asymmetry of information, you
25 have to implement some kind of sophisticated pricing,

1 which we see everywhere. It is that sophisticated
2 pricing that in fact is the explanation why we see these
3 kind of schedules in real life.
4 Now, in our model, we have a typical
5 self-selection equilibrium that comes about. The
6 benefit from the loyalty rebate is clearly going to
7 accrue to the seller, not to the buyer, because the
8 loyalty rebate gives greater power to price
9 discrimination.
10 We don't know whether price discrimination is a
11 good thing or a bad thing as a general economic
12 proposition. In our model, we would say, look, if the
13 driver behind the loyalty rebate is to incentivize the
14 downstream, these buyers or a buyer could be either in
15 the high state or the low state, and that should be
16 enough to stop somebody trying to condemn the particular
17 loyalty rebate as being potentially anticompetitive.
18 So you can see that is the theorem right here.
19 If you compared this diagram relative to the prior
20 diagrams, you can see where the difference comes from.
21 As I said, the basic insight of that paper is
22 that loyalty rebates permit more efficient price
23 discrimination than simple two-part tariffs because of
24 the nondifferentiability of the outlay schedule of the
25 self-selection point chosen by the high-demand buyer.

1 Price discrimination is not always welfare
2 enhancing, but we don't believe there should be public
3 policy prohibitions for reasons to discourage the use of
4 loyalty rebates for such purposes.
5 Here I will stop, given that you have my slides.
6 Here are the references for those of you who are
7 interested. Greg will be happy to send you our papers
8 if you ask for them.
9 Thank you very much. And I hope I was not way
10 too confusing.
11 (Applause.)
12 MR. MEYER: Thank you very much.
13 Our final panelist is Will Tom, a partner at
14 Morgan, Lewis & Bockius here in Washington.
15 As I mentioned earlier, Will has also been the
16 deputy director at the FTC's Bureau of Competition.
17 MR. TOM: Thank you very much, David.
18 I will make up for Janusz's too many slides by
19 having none at all.
20 I am also going to free ride on all the previous
21 panelists, both this morning's and this afternoon's, by
22 assuming that you have heard all their presentations,
23 you are now up to speed on all that they have said.
24 So I will not rehash any of the previous
25 discussions or points that were made, which may lead

1 some of you to wonder whether there is anything more
2 left to be said after all of the education that you have
3 gotten.
4 I do think that one of the things that comes out
5 pretty clearly in hearing the lawyers and the economists
6 and listening for some of the differences between what
7 they are doing here is that the lawyers are looking for
8 rules that you can apply in real litigation situations
9 and a state of imperfect information.
10 We have had a lot of talk about the precise
11 contours of those rules and what models can guide us in
12 formulating what those rules are.
13 At least for us simple-minded lawyers, the
14 attraction of the incremental revenue versus incremental
15 cost or Ortho standard or whatever you want to call it
16 is that it is simple enough for us to understand, and it
17 can actually provide some guidance. It provides
18 guidance on which most lawyers for a fairly wide
19 spectrum of so-called Chicago School or post-Chicago
20 School adherents can agree on.
21 But it obviously provides that guidance only
22 when the incremental costs and the incremental revenues
23 are known.
24 And it seems to me that the interesting problems
25 in actually deciding the cases is how the case should be

1 decided in the large number of cases where it is not
2 known or where that is the very subject of the
3 litigation, with the two sides arguing for different
4 factual inferences.
5 One of the things that struck me in hearing the
6 lawyers talk, particularly this morning, is that there
7 wasn't a lot of mention of the legal framework and the
8 legal doctrines by which these kinds of rules were
9 introduced in the first place, particularly in the
10 predatory pricing scenario.
11 The question for the factfinder in these rule-of
12 -reason kinds of cases is simply in a Section 1 kind of
13 case, a vertical case where you have a contract and
14 therefore you can bring it under Section 1, does the
15 anticompetitive harm exceed the procompetitive benefit.
16 In the Section 2 case, it is, "was the defendant
17 able to apply or maintain monopoly power as a result of
18 the conduct or did it dangerously threaten to do so?"
19 And the way the rules and the economics come
20 into play is in helping the court decide what kinds of
21 inferences are permissible from the evidence, or in the
22 words of a famous case from way back in the '60s or
23 '70s -- I guess I'm showing my age -- if a frog be found
24 in the party punch bowl, one can infer the presence of a
25 mischievous guest, but not the presence of spontaneous

1 generation.

2 That is the role of economics or that has been
3 the role of economics. That's how it has guided us in
4 the question of what inferences are possible, what
5 inferences are reasonable, from the facts that are
6 given.

7 So suppose, to take a hypothetical or a
8 paraphrase of a hypothetical that was used within the
9 Supreme Court in the last couple days, suppose you had
10 board of directors' minutes that said we are adopting
11 this practice even though it will be costly, even though
12 it is not going to earn us any profits because it will
13 cut off our rivals' air supply and ensure we will not
14 have serious competition for a generation.

15 In the absence of proof by the plaintiff that
16 the Ortho test is failed, can defendant get summary
17 judgment, or does plaintiff get to a jury, having
18 presented that evidence?

19 Well, I guess those of us who still remember the
20 law school side of the house -- and I realize that all
21 of us antitrust lawyers have slowly gravitated over the
22 years to being economists that simply haven't studied
23 enough to get a degree have to ask, what is the legal
24 framework, what is the legal system, how does the law
25 control what the role of the district judge is or what

1 the role of the jury is, what the role of the Court of
2 Appeals is?
3 You would think that that case goes to the jury,
4 at least unless defendant can prove that this could not
5 possibly have caused the acquisition or maintenance of
6 monopoly power.
7 Now, it may be that people write documents all
8 the time, as someone earlier said, that they don't mean
9 or they are just deluded, and there may be a defendant
10 who can prove that. A lot of the real questions in
11 these areas devolve into questions of burden of proof.
12 When you get to the question of when is the
13 legal system confident enough to take those kinds of
14 questions away from the factfinder and to impose rules
15 that say this case cannot go to the jury, we will decide
16 it as a matter of law that such an outcome is right, you
17 are really looking for the kind of confidence that we
18 have in the predatory pricing area.
19 I think Tim started out his presentation with a
20 little bit of a refresher course on decision theory,
21 which I think is very apt, that we are all trying to
22 minimize the administrative costs plus the costs of
23 error, and having sensible administrable rules to do
24 that is a very valuable thing to do.
25 But at the end of the day, the question is in

1 order to have a basis for applying that kind of rule, do
2 we have the kind of confidence that the cost of the
3 false positives in this kind of setting is going to so
4 swamp the cost of the false negatives that we should
5 simply say no, this kind of inference is not
6 permissible.
7 And I think, to borrow again from things that
8 I'm sure Tim Muris and others have said, one of the
9 virtues of the market is that it tends to be
10 self-correcting; whereas, misguided government
11 intervention tends not to be self-correcting, but,
12 rather, is persistent for a long time.
13 I think we should be cautious in this area as
14 well in applying per se rules that essentially cut off
15 the debate and end up not being self-correcting,
16 because, of course, if these instances of loyalty
17 rebates are per se lawful, unless plaintiff meets the
18 burden of proving something that is very difficult for
19 plaintiffs to prove, then those cases will never be
20 brought and you will not have the opportunity for the
21 development and refinement of those legal rules.
22 So I think I am much more comfortable with
23 presumptions and with rules of thumb that can be
24 overcome in the particular case. And in this
25 connection, I am somewhat taken by Dan Crane's

1 suggestion that the legal standards might be different
2 purely in injunctive cases from the treble damage
3 situation.
4 I do think that to a large extent in antitrust
5 laws, our view of the substantive legal rules are shaped
6 by the institutional setting in which those rules are
7 developed, and properly so, because that tells you what
8 the cost of the false positives are, at least to some
9 extent.
10 In a setting where you don't have treble
11 damages, where the relief is purely prospective, you can
12 perhaps afford to experiment a little bit more or to be
13 somewhat more precise in the way you apply complex legal
14 rules or complex economic theories.
15 Here I am not going to please the Department of
16 Justice representatives or any of my former colleagues
17 at the Department of Justice. Because of the different
18 institutional settings that apply to those two agencies,
19 it is much easier for the Federal Trade Commission to do
20 that sort of thing than for the Department of Justice.
21 I have long found the portion of the Areeda-
22 Turner treatise that talks about applying a lower
23 substantive standard in Department of Justice injunctive
24 proceedings somewhat problematic because they are
25 applying the same statute that is applied in private

1 cases, and to some extent the court doesn't have the
2 freedom to write different rules for the two different
3 sides, unlike Section 5, which is entirely different.
4 Indeed, if you go back and look at the
5 legislative history of the Federal Trade Commission Act,
6 it seems to be one of the very purposes for which the
7 Commission is created is to explore some of the cutting
8 edges, if you will, of the law and allow this expert
9 body to define prospective rules of the game in a way
10 that doesn't punish companies for past conduct that they
11 did not have reason to believe was unlawful.
12 I think given how much there is to talk about
13 among the panelists and how late it is in the day, I
14 think I will stop there and leave as much time as
15 possible for any discussion.
16 Thank you.
17 (Applause.)
18 MR. MEYER: Thanks very much. I think we will
19 take about 10 minutes as our break. It looks like it is
20 about quarter to three.
21 If we could all be back here in five minutes to
22 the hour, that would be great.
23 (Recess.)
24 MR. MEYER: We are ready.
25 We will start, as I said, with an opportunity

1 for each of the panelists to comment on or reply to or
2 question the others about their remarks.
3 Just to shake things up a bit, I'm going to
4 suggest that we alter the order and start with Dan.
5 PROFESSOR CRANE: Sure. I guess I would like to
6 respond to one thing that Will said, which was the
7 hypothetical memo to the board of directors about the
8 reasons for a discount and how it could be exclusionary
9 of rivals.
10 The problem I would have with a legal standard
11 that focused on the intent of the defendant is that
12 usually it will not be a memo to the board of directors
13 but an e-mail to some third-tier manager that has some
14 inflammatory war metaphors for its metaphor about
15 crushing a competitor. And it won't be just one, it
16 will be three or four or five or six of these strung
17 together from millions of documents. You will always
18 find these in someone's files.
19 Although the memo to the board of directors
20 might be better evidence, in private litigation, if we
21 even raise intent as a consideration, it is those third
22 and fourth-tier manager e-mails that will become the
23 evidence that get to the people in the jury, even though
24 those e-mails really tell us very little about the true
25 efficiency consequences of the bundled discount program.

1 I agree with Richard Posner that intent evidence
2 is evidence of anticompetitive conduct only two people
3 who sort of are foolishly taken by sort of aggressive
4 language. And juries certainly can be influenced by
5 that.
6 I think in the Brooke Group case, the post-jury
7 or post-trial interview showed the jurors had no
8 understanding about oligopoly, the average variable cost
9 test, but they were highly influenced by Brown and
10 Williamson's war documents. To me, that is not a good
11 standard.
12 MR. MEYER: Thanks very much.
13 Janusz, any thoughts?
14 PROFESSOR ORDOVER: I think that we are all
15 pretty much in agreement on a lot of aspects of how to
16 approach these kind of business practices.
17 My only question would be actually to Tim Muris,
18 whether or not we really have that much faith in
19 experimental economics to create the edifice of a big
20 chunk of antitrust laws, what it is that
21 well-incentivized graduates, undergraduates or even
22 faculty of the law school can do in these games.
23 I historically have been rather skeptical of
24 experimental economics. In this case, I think my
25 skepticism is probably heightened by virtue of the fact

1 that the kind of environments in which litigation
2 actually takes place, the market settings in which the
3 actual litigations take place are very hard, I think, to
4 reproduce in the pure experimental setting.
5 I'm not saying there is no insight to be gained.
6 I'm trying to figure out whether or not this is enough
7 to say that we should allow X or that we should disallow
8 Z. I would say it is not.
9 It may be an interesting angle to look at
10 matters through the prism of these experiments. But I
11 would hate to have someone go to court and say that
12 Professor Vernon Smith, how much I admire his work over
13 the years, has shown that the experimental setting with
14 three firms, a bunch of graduates, X, Y, and Z cannot
15 happen, therefore the case should be dismissed.
16 I don't know whether you would go there. But I
17 would say that one shouldn't even try to go there.
18 That's my strongest reaction.
19 As to the Ortho test, of course I find it rather
20 attractive. The problem in that setting again, the test
21 was somewhat limited as to the broad application,
22 because it did involve again a very specific set of
23 relationships.
24 There was only one buyer, Red Cross, which
25 needed a whole panoply and did specify a whole panoply

1 of red blood tests that it needed, and it commanded the
2 two offerors to give them bundled and unbundled pricing.
3 Where the issue arose, where I really fell down
4 flat on my face, was because we had no cost data for
5 anybody to be able to apply any of these scratchings on
6 the napkin that I have generated as a foundation for
7 this whole analysis.
8 But again -- so now the question does arise
9 whether what the court did there and how they looked at
10 the allocation of margins and so on would be directly
11 translatable into other circumstances.
12 So from an intellectual standpoint, the source
13 of that test is of course the so-called compensatory
14 pricing test that Bobby and I have invented since 1980.
15 I'm sort of asking myself those questions
16 because I see the possibility for the application. But
17 I also understand the limited setting in which the test
18 actually had its traction may not have the kind of
19 traction that we would need in other contexts.
20 MR. MEYER: Thanks, Janusz.
21 When DOJ develops and opens its museum on
22 loyalty discounts, it will ask you to donate that
23 napkin.
24 PROFESSOR ORDOVER: I think it is part of the
25 record. Mr. Weinstein, whoever was the lawyer for the

1 other side, actually he attached it to my deposition.
2 It should be someplace. I think I have it.
3 MR. MEYER: We will leave no stone unturned.
4 Since you have now posed two questions for Tim,
5 one that you just asked him about, experimental
6 economics, and the earlier one about age and looks, Tim,
7 you can respond now.
8 PROFESSOR MURIS: We will leave the second one
9 to a market test.
10 Let me make four points. You will probably hear
11 me either way. The first is just a point I repeatedly
12 make to the world, which is that when people say
13 Chicago, they are talking Posner and Bork, who don't
14 even -- Posner and Bork are the most extremely
15 differentiated on mergers. But Posner and Bork had
16 certain views that were not the views of a so-called
17 Chicago economist.
18 I don't consider myself a Chicago economist. I
19 like what is called the new institutional economics.
20 As a matter of fact, what is called Chicago
21 economics before 1960 invented and dismissed as
22 empirically irrelevant raising rivals' costs, variable
23 proportions as an explanation for why tying is
24 anticompetitive and why, RPM could be anticompetitive in
25 certain circumstances, all this by 1960.

1 Posner and Bork came along, particularly in the
2 vertical practices, with what I think was a restrictive
3 and extreme view.
4 On experimental economics, there are some
5 economists who are concerned about experimental
6 economics. I think there is enormous validity to
7 experimental economics in the sense that basic
8 theoretical propositions of economics are verified in
9 the lab.
10 The beauty of the experiments is that one can
11 take Janusz's paper, which I obviously haven't studied
12 and deals with a different problem than was modeled in
13 the bundling, you could take that paper and you could
14 run it in the lab and run various differences and see
15 what happened.
16 In this world, for better or worse, experimental
17 economics is the one-eyed man in the kingdom of the
18 blind.
19 We are dealing with almost complete ignorance
20 about the empirical effects of bundling. We are taking
21 a ubiquitous practice in nonmarket power settings and
22 saying in market power settings there are problems here
23 based on an extreme set of assumptions.
24 My third comment is about bright-line rules,
25 which Will was talking about. Even -- I guess this will

1 turn out to be a point that Janusz may want to talk
2 about as well.
3 Even in Brooke Group, which appears to be a very
4 bright-line rule, courts are pushing it. Janusz
5 testified for Northwest in the Spirit -- is that --
6 PROFESSOR ORDOVER: Yes, I did successfully the
7 first time around.
8 PROFESSOR MURIS: Right, right.
9 The point is that the Sixth Circuit, Brooke
10 Group or no Brooke Group, was pushing the envelope
11 there.
12 And I think what we ought to do is look at the
13 world as we know it, and the world as we know it is a
14 world in which LePage's has caused lots of damage. We
15 have highly theoretical evidence of problems without
16 real world evidence.
17 Of course, the experiments were designed to push
18 and test and find exclusionary bundling and didn't. But
19 someone can go run modifications if they want, which
20 leads me to my fourth point, which is the Ortho test.
21 The Ortho test, as they say, Parker, is
22 obviously much better than the standard LePage's world.
23 The problem is that it is so easy for -- one of many
24 problems with Ortho besides the fact that it would
25 condemn efficient practices is that it is so easy to

1 turn the safe harbor into the test.
2 I assume Professor Crane would reject that.
3 Professor Hovenkamp rejects that. But it would be very
4 easy to cross over that line.
5 When you are shifting presumptions makes a
6 difference. One of the interesting things on the
7 Twombley argument Monday was Justice Stephens through
8 the course of the argument, it appeared -- who knows
9 exactly, obviously -- it occurred to him that if he
10 allowed the complaint, from his questioning, if you
11 allowed the complaint, there was going to be some fact
12 that was going to survive a motion for summary judgment.
13 As a practical matter, maybe you did want to
14 scream at the complaint level. I wrote an amicus brief,
15 along with some other people at O'Melveny, supporting
16 the petitioners in Twombley. So I obviously have a dog
17 in that hunt.
18 Recognizing these real world practical
19 considerations, as Will and others have said, is
20 absolutely essential.
21 MR. MEYER: Thanks.
22 Will, your final opportunity.
23 MR. TOM: Let me just respond to Dan Crane's
24 last remark by repeating something that Joe Kattan said
25 this morning, and that is "intent to do what?"

1 I think there is a danger in a lot of these
2 areas in using broad classifications to stand for a
3 whole bunch of disparate things, and that applies to
4 evidence as well as it does to some of the economic
5 issues we have been discussing here today.
6 I think most courts nowadays confronted only
7 with the intent evidence that says "let's crush our
8 competitors" would say that that is insufficient
9 evidence to go to the factfinder.
10 Whether you should then sweep into that every
11 other piece of evidence that you find in an internal
12 company document I'm highly dubious about.
13 MR. MEYER: Okay. With those comments, I think
14 we will turn now to the propositions.
15 In these hearings, we have been using
16 propositions merely as a starting point for discussion
17 and not necessarily as a set of propositions that
18 reflect the agencies' views either for enforcement or
19 otherwise.
20 If we go to slide 3, we will start with this. I
21 think perhaps we might have something like agreement,
22 but I will ask.
23 The proposition is the LePage's decision's
24 vagueness is likely to chill pricing behavior that
25 enhances consumer welfare. Agree or disagree?

1 PROFESSOR ORDOVER: I agree.
2 MR. MEYER: We all agree?
3 PROFESSOR CRANE: I do agree. And from a
4 client-counseling perspective, I have been on a number
5 of calls in cases where someone is not a defendant but
6 simply trying to figure out what they can do and what
7 they can't do.
8 Without being too specific, for attorney-client
9 privilege reasons, if you have any moderate degree of
10 risk aversion, you can guess what the answer is.
11 It is oftentimes the case that you probably
12 wouldn't get sued, but you don't want to be the person
13 who gives the advice that we could bring in the smart
14 economist and convince the court to dismiss the case on
15 summary judgment.
16 You tell them you don't want to invite
17 litigation at all and it is always better to try to
18 unbundle a discount than to face the prospect of
19 litigation.
20 MR. MEYER: I certainly understand the need to
21 mask the specific facts. But are the situations that
22 you are describing ones where, at least in the mind of
23 the company involved, there is a clear pro-competitive
24 motivation or rationale for wanting to structure a
25 discount program and they are asking can we do this

1 without fear of litigation or is it where they have the
2 structure and they are being asked is this going to pose
3 problems?
4 PROFESSOR CRANE: It really varies. Even what a
5 pro-competitive justification is I'm not always clear
6 on.
7 There are certainly cases where clients are
8 asking. Sometimes these bundled discounts are customer
9 driven, and large diversified buyers are putting
10 pressure on sellers to give them a concession for
11 buying, and that is simply responding to pressure from
12 the client.
13 Sometimes there is a question simply about using
14 as a competitive advantage, not to necessarily exclude a
15 rival, but because you think you can increase your
16 market share through a discount that takes advantage of
17 your diversification.
18 I think certainly I tell the client if the
19 discount is one that looks like it is going to really
20 harm the competitor to the point of extinction,
21 obviously you shouldn't do it. Even far short of that,
22 clients often think about this as a competitive
23 strategy.
24 PROFESSOR ORDOVER: Would the answer differ in
25 the following two settings?

1 One, there are bundled discounts but we have
2 something called mixed bundling. In other words, you
3 offer a bundle, there is a good price, like the one that
4 ABA offered for two volumes of writings, but there is
5 also a stand-alone price.
6 Because of the not total disattractiveness of
7 the stand-alone prices, people can avail themselves of
8 buying one of the volumes and then buying a substitute
9 product somewhere else. But there are recognizable
10 efficiencies from bundling.
11 Does one get protected under any of these
12 LePage's standards or their progeny from the challenge
13 if you do indeed offer mixed bundling and you also
14 demonstrate that people are buying at the stand-alone
15 price?
16 PROFESSOR MURIS: That's an important point. I
17 think the hypothesis of the attack with LePage's is you
18 don't have a de facto time. It is calling it mixed
19 bundling.
20 MR. MEYER: Is the problem with LePage's from
21 the perspective of its vagueness and potential to chill
22 behavior, which I think we all agree to, is the problem
23 the lack of a safe harbor, the lack of a concrete cast
24 or the focus on the impact on rivals or something else
25 or all of the above?

1 PROFESSOR CRANE: I think it is the lack of a
2 concrete test. Even though we had the Ortho standard,
3 it would be sometimes hard in a client-counseling
4 situation to anticipate how that would come out in
5 practice.
6 I think most bundled discounts would clearly
7 meet the Ortho safe harbor. And it is not even a
8 question of most cases.
9 What I think that would do is change the culture
10 of this issue in the courts, where you could tell a
11 client that only in really sort of egregious cases of
12 bundled discounting that has a clearly exclusionary
13 effect on single-product rivals will a court condemn it.
14 That will certainly change your willingness to
15 say go ahead and do it.
16 MR. MEYER: Let's turn to proposition 6.
17 This problem situation is as follows: Because
18 lower prices immediately benefit consumers, we should be
19 extremely careful not to adopt legal rules that can
20 result in false positives, that is, condemn legitimate
21 price cutting.
22 Do we agree or disagree with that proposition?
23 MR. TOM: I think the disagreement here will be
24 more on whether this proposition is one that is relevant
25 to the loyalty discount kind of setting rather than

1 agreement or disagreement with the proposition itself.
2 I think we all agree that in general we like
3 lower prices to consumers as long as it is not an
4 exercise of monopoly power. You will not get a lot of
5 disagreement on that.
6 MR. MEYER: Is your question, Will, whether in
7 certain situations the loyalty rebates that are being
8 offered to particular customers actually result in the
9 overall prices paid by them being higher rather than
10 lower in the short term, or is this a long-term versus
11 short-term problem you are identifying?
12 MR. TOM: Even in the short term, there are
13 issues of what would the stand-alone prices have been,
14 absent allowing it.
15 MR. MEYER: Have we seen any cases where the
16 prices in the short term were higher?
17 MR. TOM: There was one mentioned this morning.
18 PROFESSOR CRANE: The SmithKline case this
19 morning.
20 The discussion this morning was that in
21 SmithKline, the offer was a 3 percent increase
22 accompanied by a bundled discount to buying the package,
23 which would suggest there was the possibility that even
24 in the short run, the defendant was not sacrificing
25 profits immediately by taking market share from

1 single-product rivals.
2 MR. MEYER: Fine. Going back to the beginning
3 here and with Will's amendment, if the bundled discount
4 or loyalty discount results in lower prices in the short
5 term, we all agree that care should be taken to avoid
6 chilling such conduct?
7 PROFESSOR MURIS: I agree. Let me add, I wasn't
8 here this morning, but I assume that Professor Nalebuff
9 was probably the most aggressive on behalf of his
10 various rules.
11 If you look at Tim Brennan's comment on his
12 paper, it shows that in the equilibria, consumers are
13 better off in the short run virtually all the time.
14 That's the nature of excluding, what it means.
15 So the theory is really a long-run theory. It is not a
16 theory in the model. But that is really the theory.
17 And that's I think a very strong reason to agree with
18 the proposition that we need to be very careful.
19 PROFESSOR ORDOVER: I think to emphasize what
20 Tim said, I agree 100 percent. And that is in order to
21 close the model of these adverse effects, you really
22 have to have the second stage or the third stage and
23 when something bad actually does happen from a price
24 discount, unless you can show that, you don't have a leg
25 to stand on in the rest of the case.

1 It could be a complicated set of issues to be
2 addressed, these intertemporal linkages, the R&D
3 incentives. But if the marketplace is not of the sort
4 that it is susceptible to exclusionary conduct over a
5 long haul, then I think we should really be very
6 protective of price cutting.
7 I think where the problem comes in is much of
8 the literature on loyalty rebates, as summarized in much
9 of Professor Elhauge's writings, actually show this
10 concept -- sort of like the rug carpet dealership or the
11 vitamin store where you always get 20 percent off. They
12 don't say what the benchmark over which you are
13 discounting is.
14 There is that issue. The equilibria in many of
15 these games, the discount is off of what appears to be a
16 super-monopoly price, and then really it boils down to
17 another point Tim made very importantly earlier today,
18 which is to say is that a credible threat for the
19 incumbent firm to say if you don't buy it from me, I
20 will charge you monopoly price plus 15 percent on top of
21 that.
22 Again, that is a complicated analytical issue,
23 whether or not this is a credible threat or not. It
24 really much depends on how you view this monopolist
25 power to guide the transactions.

1 After all, you can say the same thing to a
2 monopolist who says, "look, I'm charging you $10 for the
3 widget." You say "hell with you, I'm not paying $10."
4 He says, "okay, okay, I will charge you 9." Then the
5 whole thing begins to unravel.
6 Every monopolist issue is that of credibility.
7 I think as Carlos pointed out, when the monopolist
8 cannot stick credibly to his threat, the monopolist
9 competing against himself will drag the price down to
10 his marginal cost.
11 We have the same question here. How credible is
12 the super-monopoly price as a way to enforce an
13 equilibrium in which everybody is paying close to
14 monopoly price, which is what the outcome is in the
15 naked exclusion model.
16 That's the story of that basic model which
17 Elhauge finds very attractive.
18 MR. TOM: For a clarification point, aren't most
19 of these models that are based on a super monopoly price
20 for the monopolized good and a discounted price for the
21 competitive good ones in which commitment is not
22 necessary because the purchaser of the bundle does not
23 face a price increase? That is, the excess of the
24 monopoly price on good A is no greater than the discount
25 on the competitive price.

1 PROFESSOR ORDOVER: You end up in equilibrium
2 with something close to the monopoly price. In the
3 naked exclusion model, you end up with an equilibrium
4 where everybody is getting a penny off the dollar price.
5 That is again supported by what some people may
6 consider not credible threats of how the firm will
7 behave out of equilibrium.
8 That is the same problem in all of these models
9 potentially, actually, other than the Ordover-Shaffer
10 model in which the equilibrium is supported by credible
11 contracts.
12 I'm talking about game theory stuff. I don't
13 know whether it makes any difference to anybody here.
14 If you are trying to be serious about it, you try to
15 model it seriously. It is very difficult because it
16 does require this credibility.
17 MR. TOM: The credibility issue is that you will
18 still give the discount on the below marginal cost on
19 the competitive product even if he doesn't buy the
20 monopoly product?
21 PROFESSOR ORDOVER: Right. Or if somebody
22 refused to transact with you, that you will not revise
23 the market off.
24 MR. MEYER: Didn't you mean the other way
25 around? If you don't buy the competitive product, the

1 monopolist will still charge just the monopoly price,
2 not the super-monopoly price.
3 PROFESSOR MURIS: Right. A couple points.
4 On FTC.gov, you can find in terms of naked
5 exclusion the originator of the concept, Michael Winston
6 -- unfortunately, this was a workshop we had that turned
7 out to be on September 11, 2001, which was a pretty
8 crazy day.
9 Anyway, the economists, they all stayed and
10 talked. And he said he didn't have a clue whether this
11 has any empirical significance or not, which I think is
12 an honest position.
13 In terms of the super-monopoly price, the
14 de facto time is the special case here. The reason the
15 Nalebuff thing is so important if it had empirical
16 significance is it is above-cost exclusion with mixed
17 bundling.
18 One of the interesting results of the
19 experiments that I did talk about is mixed bundling
20 still occurs a lot, virtually under every setting.
21 Mixed bundling again being where they are selling the
22 stand-alone as well as the bundle offering and selling
23 it.
24 And a further point of interest of the
25 experiments and in terms of -- remember, when you talk

1 about exclusionary behavior, we are all agreeing the
2 point is on welfare, not on excluding competitors.
3 When ICES tweaked their model to try to really
4 push and show that bundling decreased welfare, they did
5 show big-time exclusion. But they showed very small
6 reductions in welfare, not statistically significant,
7 even under very extreme assumptions.
8 MR. MEYER: Let's go to proposition number 5, if
9 we could.
10 PROFESSOR MURIS: I think he is trying to
11 confuse us.
12 PROFESSOR ORDOVER: Like Lenin, two steps
13 forward, one step back.
14 MR. MEYER: I think the comments that Janusz and
15 Tim made may be a good segue to this proposition, and
16 that is a loyalty discount that allows a competitor to
17 operate profitably at some scale can never be harmful to
18 consumers.
19 Anyone want to take that one on?
20 PROFESSOR ORDOVER: I think that to use such
21 things as "never," even in the proposition --
22 MR. MEYER: How about taking it on as usually
23 can't?
24 PROFESSOR ORDOVER: I think we just don't know.
25 I think if the competitor can operate profitably, then

1 there has to be a showing to condemn the practice that
2 somehow that scale which it can operate is so
3 sufficiently constricted as to render basically the
4 competitor, the rival marginally profitable, much less
5 constraining of the market outcome than in a less
6 constricted equilibrium.
7 So the question is that of the benchmark,
8 really. The consumers benefit from having competition.
9 If the scale is sufficiently large, the
10 competitor cannot be profitable and exert competitive
11 pressure. Then I would say that's good enough. If the
12 competitor is completely marginalized, it is one of the
13 few competitors that can exert any kind of competitive
14 pressure, I believe that possibly could be a
15 circumstance that may require some remedial
16 intervention.
17 MR. MEYER: Others?
18 PROFESSOR MURIS: Let me preface this by saying
19 all of my comments reflect this basic framework of the
20 efficient legal system.
21 George Stigler once wrote a piece where he just
22 numbered the comments, the first one, of course, being a
23 Chicagoist, this is just a coast theorem.
24 Everything I'm saying is in the context of
25 efficient legal rules. Here the models that people are

1 positing are models of complete exclusion. If we have
2 quote partial exclusion, Janusz is absolutely right; I'm
3 sure you can conjure up a situation where that is bad.
4 As a practical matter we ought to be cautious if
5 the exclusion is partial in terms of false positives.
6 PROFESSOR ORDOVER: I agree. The European
7 Union's white paper, pink paper, whichever color they
8 use on anticompetitive conduct has some complicated rule
9 dealing with something called the suction test and the
10 loyalty rebates.
11 I tried to figure out what it means empirically,
12 how to apply it. It strikes me as a rather difficult
13 undertaking.
14 If the competitor can operate profitably, the
15 burden shifts drastically against the complaining rivals
16 to show that something else could have happened but for
17 this conduct that truly would benefit welfare.
18 I would apply a very strict test to what it is
19 that can be shown or should be shown. It was a minimum
20 showing in such a circumstance from the competitor.
21 MR. TOM: In fact, you are looking for the
22 rival's marginal cost to be raised in such a way that
23 the perpetrator can raise prices.
24 MR. MEYER: In the spirit of jumping around, I
25 think we will go to slide 8.

1 We have already heard a little bit of debate
2 about this in the earlier dialogue, but to state this
3 proposition. In a loyalty discount case "intent is
4 relevant to proving monopolization." Quoting from
5 LePage's.
6 I will start this, conscious of the prior
7 comments, by first asking whether if you have intent --
8 maybe we can all agree on this. If the evidence is
9 simply that the defendant intended to cause harm to his
10 rivals, to drive its rivals out of business, to raise
11 their costs, to steal sales from them, is that ever
12 enough to get to a jury?
13 PROFESSOR CRANE: Just to repeat what I said
14 before, part of the problem is I don't know what a
15 corporation's intent is.
16 A corporation is a fictional person. Will's
17 suggestion that we can't simply lump all intent in the
18 same category maybe is right in theory.
19 When you get to actual litigation, if the legal
20 standard is framed as an intent-oriented standard or one
21 where intent is a relevant proposition, how do we
22 separate out the different kinds of intent and at what
23 stage in the litigation?
24 Is this a role for the court in summary judgment
25 to sort of talk about different kinds of intent and sort

1 of sort them out as a screening device?
2 I think that would get rather difficult to do.
3 Again, it would also create a predictability problem.
4 In most cases, the objective economic evidence
5 will be available for something like the Ortho test, and
6 it really should not be necessary to go to intent.
7 MR. MEYER: Any other reactions to the first
8 question?
9 MR. TOM: To your specific question, certainly I
10 think everyone would agree on 1 and 3. I'm not sure
11 that everyone would agree that a demonstration that your
12 plan was to raise your rival's cost would necessarily
13 get a free pass.
14 PROFESSOR ORDOVER: Competition is about killing
15 your rival, really, or diminishing its capability as far
16 as you can do that.
17 The real question is is it done in a way that is
18 conducive to consumer welfare or done in a way that
19 harms it for horizons we are comfortable to deal with,
20 whether you can sort it out efficiently without running
21 into these other problems or without having the current
22 rival abusing the system.
23 I think one should not view intent as really a
24 bunch of nasty e-mails. One should look to intent as a
25 manifestation of business practice that has a likelihood

1 of harming competition.
2 From my perspective, when I teach my kids about
3 competition, they say what do you do when you run
4 experiments at NYU, yes, you try to vanquish your rival,
5 but try to do it in such a way that is conducive to
6 welfare. Let them figure out what that means. That's
7 the true story.
8 MR. TOM: Is that the jury instruction?
9 MR. MEYER: What if instead of being evidence of
10 1 and 3, as the shorthand we will use, and I think what
11 that means, if I'm recalling my own comment, is evidence
12 of a desire to kill the rival or eliminate the rival or
13 steal sales from the rival, instead of that you had
14 documents or testimony that constituted a very detailed
15 analysis of the reasons why the business wanted to
16 engage in this practice of structuring the discounts in
17 the way they were structured that had appeared on its
18 face to have nothing to do with hurting the rival or
19 excluding the rival.
20 Would that be probative in some way?
21 MR. TOM: It seems like it would be probative of
22 an efficiency justification or lack of competitive
23 effect, if I'm understanding your question right.
24 PROFESSOR ORDOVER: It could be probative of the
25 fact that the practice makes sense, that the competitive

1 practice irrespective potentially of how it affects the
2 competitive marketplace, if that's your question.
3 PROFESSOR MURIS: Under Brooke Group, since I'm
4 arguing for modified Brooke Group, you have this
5 price-cost safe harbor. If you fail that, you need to
6 show the entity competitive effect. There are obviously
7 places where the law makes intent relevant, including
8 Norr Pennington, for example, especially in the
9 so-called pattern case because of the nature of the
10 First Amendment protection.
11 But here I think you need -- this is one of your
12 other propositions, if I'm jumping the gun. I think you
13 do need price-cost benchmarks to start with.
14 PROFESSOR CRANE: Intent is certainly relevant
15 in an attempt-to-monopolize case, because intent is a
16 specific intent crime and the Supreme Court has made
17 clear that intent is relevant.
18 But intent in a case like Spectrum Sports would
19 only come in in addition to a showing of exclusionary
20 conduct.
21 As to that element, a legal defense might
22 concern LePage's in that it seems to make intent part of
23 that element of the offence, which is anticompetitive or
24 exclusionary conduct, which seems to suggest that even
25 if you have weak evidence, sort of economic evidence of

1 exclusionary conduct, that intent can make up for the
2 weakness in that showing, which I think should not be
3 right.
4 MR. MEYER: What are your thoughts on this
5 question? Can good intent save you even if it turns out
6 that you were wrong?
7 For example, there are detailed analyses that
8 all the prices are going to be above cost, no matter how
9 you measure them incrementally or in the aggregate, and
10 it turns out there was a math error. How does that case
11 come out?
12 PROFESSOR CRANE: That's the historical accident
13 standard, where you monopolize completely by mistake. I
14 will use that on my antitrust exam. It is a
15 hypothetical case.
16 I don't think the defendant should have a
17 defense that we had benign intent. But, of course,
18 pro-competitive justifications as the explanation for
19 the conduct could be like the defendant's intent. I
20 think, of course, that's always permissible.
21 PROFESSOR ORDOVER: Especially in certain areas
22 of business conduct, for example, R&D, research, it may
23 turn out it is more costly than you planned or more
24 successful than you thought it was going to be.
25 When you have business activities with

1 themselves, random outcomes hard to predict, it is key
2 that one should not hang somebody for a circumstance
3 that is one of the possible many outcomes, most of which
4 or at least ex ante believe that you are going to be
5 acting in a pro competitive manner.
6 If you embark on an R&D program which may cause
7 some problems for your competitors but it turns out you
8 are now going to be spending 10 percent more, somebody
9 said if you knew you were going to spend 10 percent
10 more, now you are killing us.
11 It is the sort of ex ante nature of the
12 calculation that is the right way to look at it.
13 MR. MEYER: Janusz, you promised one step back.
14 We will go back to slide 7.
15 PROFESSOR ORDOVER: I'm no Lenin.
16 MR. MEYER: Loyalty discounts, either single
17 product or bundled, should never be condemned without
18 applying some kind of price-cost test.
19 Tim, I think you said you agree with that.
20 PROFESSOR MURIS: Sure, for the reasons of
21 administrability and an efficient operation of the legal
22 system.
23 PROFESSOR CRANE: I would add in addition to
24 what Tim said also just for the purpose of disciplining
25 litigation.

1 The problem with sort of open-ended standards
2 that don't contain sort of concrete legal rules is that
3 the district courts tend to interpret these as
4 invitations to punt issues downstream to juries, and
5 that then leads to forced settlement because people are
6 risk averse and don't want to go to trial.
7 Part of this is not simply from business
8 planning purposes. It is also to give a more
9 disciplined structure to motions to dismiss, and for
10 summary judgment that allows very serious screening of
11 cases so that only the very most meritorious cases ever
12 make it to a jury.
13 MR. TOM: I'm not sure if this one is right or
14 not. The reason I say that is that what you are
15 essentially saying is the application, the passing or
16 failing of a price-cost test is part of plaintiff's
17 burden of proof and that without meeting that burden,
18 the plaintiff should fail.
19 Maybe that's right. Maybe we know enough about
20 these price-cost tests and we know enough about the
21 ability to prove this that it should be part of
22 plaintiff's burden.
23 On the other hand, if you take my board of
24 directors hypothetical, if you will, maybe one should
25 say, well, the ultimate question under the law as it has

1 been handed down to us is is this conduct on that
2 pro-competitive or anticompetitive.
3 Plaintiff has come forward with some evidence.
4 If defendant is able to rebut it by application of the
5 price-cost tests, then we will accept that as a trump.
6 But it is not part of plaintiff's prima facie case.
7 I don't know which one is right. Maybe the
8 economists on the panel or others can give us all some
9 empirical basis for knowing which is more likely to lead
10 to better results.
11 MR. MEYER: It sounds like your alternative
12 approach as you have described it would mean there is no
13 safe harbor that a business can rely upon but, rather,
14 that cases would go to summary judgment, past summary
15 judgment to the jury if there is any evidence from which
16 a jury could reasonably find --
17 MR. TOM: No, I don't think that's quite right,
18 because, of course, if it is a trump, if the price cost
19 is a trump, it is defendant's trump, of course the state
20 of the record on summary judgment may be such that there
21 is no question of material fact in dispute as to that
22 trump. Then it doesn't go to the jury.
23 It is really -- I think that the difference is
24 not whether these cases automatically go to the jury.
25 The difference is who has to come up with this evidence

1 and which way do these cases get decided under a state
2 of uncertainty as to the price-cost test.
3 Or another way of putting it is is our knowledge
4 of the price-cost test so superior to any other
5 knowledge that we can bring to bear on the ultimate
6 question of competitive effect that we should make it
7 part of the prima facie case.
8 MR. MEYER: Let me flip the question around a
9 little bit and ask let's say it were an affirmative
10 defense so that at summary judgment the defendant could
11 prevail if it demonstrated there was no dispute that
12 prices were above cost.
13 Is it a different answer in that case or you
14 still want to allow more of what I will call an
15 open-ended inquiry into that.
16 MR. TOM: If defendant can show that, that's
17 pretty convincing.
18 MR. MEYER: Janusz, any thoughts?
19 PROFESSOR ORDOVER: As an economist, I'm very
20 fond of tests that are clear-cut and also try to compare
21 some sort of price to some sort of cost.
22 But I think a price versus cost test is a very
23 ambiguous standard because we already have heard today
24 that there could be average price, average cost, there
25 could be marginal price vis-a-vis opportunity cost,

1 which is what the Ortho cost was, where the marginal
2 price was the incremental revenue under tests that Ortho
3 could have provided against Abbott. And the question
4 was which of the allocation of the costs ought to be
5 brought into the particular calculation.
6 So there is nothing wrong with price versus cost
7 tests. The question is is it the right test in each and
8 every case that involves possibly anticompetitive
9 conduct.
10 As an economist, I really don't know. If I were
11 to be advising petitioners, I would say let's try to
12 come up with as clear rules as we can. We ought to be
13 comfortable with understanding the meaning of the price
14 and the meaning of the cost in the test, comfortable
15 with advocating the correct price and the correct cost.
16 MR. MEYER: Is there a clear rule you would be
17 comfortable with, Janusz, as to a particular price and a
18 particular cost as a safe harbor for these kind of
19 loyalty discounts?
20 PROFESSOR ORDOVER: In the Ortho test, I thought
21 the rule, which was already my prior work and which is
22 consistent with much of the telecommunications
23 regulatory practice, where it came from, the efficient
24 component pricing rule, which is the progeny for all of
25 this, I thought was a good rule. And I would like to

1 see that be applied if possible.

2 But there could be circumstances in which one
3 can try to argue that it is not the right one, that a
4 better calculation would be to look at the average cost
5 versus average price of some sort.

6 I think that in, for example, U.S. versus
7 American Airlines, I thought that the relevant test
8 would be applied to profitability of the route, because
9 the contestable object there was the route or a large
10 portion of the route, as opposed to marginal flight,
11 which was not what the gain was all about.

12 I don't have a hard and fast rule, and I would
13 like to be able to argue for some degree of flexibility,
14 in part because different circumstances may call for a
15 different version of this thing called the price-cost
16 test.

17 MR. MEYER: Is there any rule that you would say
18 a monopolist or a firm --

19 PROFESSOR ORDOVER: Let me come back next year.

20 MR. MEYER: -- could take comfort in as a safe
21 harbor?

22 Is there some minimum least common denominator
23 in your various approaches so that you would be
24 comfortable with a rule that said these situations will
25 never be the source of Section 2 liability?

1 PROFESSOR ORDOVER: I don't think that I'm that
2 smart or that obnoxious to have such a vision.
3 Again, as I said, I said something along these
4 lines in the Ortho test. I thought that was not a bad
5 test.
6 I also think in different settings, much broader
7 increments of output ought to be the test. I think it
8 has to be looked at in the specifics of a particular
9 case as much as possible.
10 MR. MEYER: Tim?
11 PROFESSOR MURIS: I think then-Judge Breyer said
12 we just have to remind ourselves, in Barry Wright,
13 "unlike economics, law is an administrative system, the
14 effects of which depend on the content of rules and
15 precedents only as they are applied by judges and juries
16 in courts and by lawyers advising their clients" in this
17 pricing area.
18 We get ourselves away from price-cost benchmarks
19 and we are lost, I think.
20 That's what the world was like when predatory
21 pricing cases were brought at the drop of a hat.
22 I sat in a Commission conference room in 1975
23 and 1976 when the coffee case was debated, and it was a
24 case that everyone in this room would now regard as nuts
25 but was seriously being pursued as any of the above.

1 And what happened there was when Proctor &
2 Gamble was relieved from a Commission order that
3 prevented it from expanding that was the condition of
4 purchasing Folger's, it immediately marched into the
5 east into General Foods' territory.
6 General Foods, panic faced with the Proctor &
7 Gamble of the 1960s, 1970s, created horrendous
8 documents, and the FTC wanted to bring the case and they
9 voted repeatedly not to bring it, and the staff kept
10 bringing it back until they voted to bring it.
11 Again, it was a manifestation of lots of things,
12 but there were lots of predatory pricing litigation,
13 lots of uncertainty. And it was ended by Brooke Group,
14 and I think purposely so.
15 Even now we still have fighting at the edges.
16 It was ended by a test that will have some mistakes, but
17 I think it is essential.
18 PROFESSOR ORDOVER: I want to comment on this.
19 I think as you so beautifully said, the thing that makes
20 me be less sure than I generally try to be of myself is
21 that the source of that price quote status was a notion
22 that in a perfectly competitive environment, the firm
23 would not go below marginal cost. That's what it was.
24 That was the foundation.
25 The problem that we have is in many of these

1 cases that we are dealing with, all of them do not take
2 place in perfectly competitive environments.
3 Because they don't take place in perfectly
4 competitive environments, the question then becomes what
5 lessons can we learn out of a perfectly competitive
6 model that would illuminate the competitive effects of
7 these interactions in markets which are by definition or
8 by experience two or three standard deviations from the
9 perfectly competitive ones.
10 I really want to make sure that we don't get
11 ourselves entangled in this price-cost test as being an
12 economic foundation of anything. But I am perfectly
13 happy to view those as being the right things to look at
14 given the administrability and the clear-cut statement
15 that one can make to the firm that is trying to compete
16 hard in the marketplace.
17 PROFESSOR MURIS: Perfect competition exists
18 nowhere. I would agree with that.
19 My favorite example is the hot dog vendors out
20 there on the street. When they rise their price, they
21 don't lose all of their sales. That means they have a
22 downward-sloping demand curve, period.
23 That is because of transaction costs and various
24 things, not because of market power. Even Areta and
25 Turner in the article admitted that firms for lots of

1 reasons would price below something that looked like
2 marginal cost for their average variable cost proxy.
3 I obviously accept that and understand, as you
4 said, that administrability is a key part of the
5 equation.
6 MR. MEYER: I will jump to proposition 2, which
7 is an extension from the prior proposition. Maybe we
8 will make progress if you will move backwards.
9 This is a quote from Herb Hovenkamp's recent
10 paper.
11 "Single-product discounts should be per se
12 lawful if the overall price for all units exceeds cost."
13 Janusz, why don't we start with you.
14 PROFESSOR ORDOVER: I was paying attention to
15 something else.
16 MR. MEYER: Talking about various price-cost
17 tests and situations where you thought a broader
18 calculation of price cost -- is this one?
19 PROFESSOR ORDOVER: I think, again, it much
20 depends on the circumstances. I think that if the
21 average price is above cost, then again there is a
22 burden-shifting exercise saying, well, there are these
23 discontinuities or jumps in the loyalty schedule and
24 they have potentially serious competitive effects.
25 Is there a reason why we should not look at the

1 average price versus average cost as being the right
2 indication of how competition will play itself out?
3 It could be that in some particular settings,
4 comparing the two averages may just be inadequate in
5 trying to really sort out all the potential competitive
6 effects. But I would try to do that through the burden
7 kind of shifting as opposed to per se blanket rule.
8 In particular, in Ortho it was quite clear that
9 Abbott was going to get an average return on all of its
10 five tests that were way above its total average cost
11 across these five tests. There was still a potential
12 competitive issue.
13 MR. MEYER: This statement is limited by its
14 terms to a single-product situation.
15 PROFESSOR ORDOVER: Wait a second. If you
16 believe in the competitive equilibrium model, every good
17 is a single different thing.
18 We shouldn't get all hung up on this just
19 because I called something -- there is something to be
20 said about the uniformity of widgets versus not.
21 But what about airline flights? Is flight 05
22 the same product as flight 07? How should we look at
23 it?
24 We have to try to think a little bit more
25 broadly as opposed to saying this is a bundled rebate

1 and therefore two different products as opposed to the
2 single product and, therefore, the 17th widget is the
3 same thing as the 15th widget. That is all true.
4 In particular circumstances, the 17th widget
5 gets a certain kind of weight in how the equilibrium
6 outcome looks that you have to try to pay attention to.
7 In my opinion, we should not hide behind just
8 the differences in the product names but in the economic
9 circumstance that is driving it.
10 PROFESSOR CRANE: To the extent this is directed
11 at the Concord Boat situation as opposed to the LePage's
12 situation, it is correct. One can imagine circumstances
13 where single product loyalty discounts or volume
14 discounts, market share discounts could have
15 anticompetitive consequences.
16 The same sort of discipline that one needs in
17 litigation for bundled discounts also applies in cases,
18 in fact, applies arguably even more in cases involving a
19 discount on a single product.
20 I think this actually is a law today in Brooke
21 Group quite clearly and it is appropriately law.
22 MR. TOM: Let me just take exception to that.
23 I actually find what you just said a little bit
24 surprising in light of the fact that you were defending
25 an incremental revenue, incremental cost test in the

1 multiproduct situation. And I think Janusz is
2 completely right, that it can be very difficult to
3 distinguish single product from multiproduct situations
4 as a theoretical matter.
5 So in terms of appropriate safe harbors, the
6 ones that we have mostly had on the table today have
7 been either incremental revenue, incremental cost or
8 average revenue, average cost, which I think Professor
9 Muris was advocating.
10 I think this proposition can only be justified
11 on the administrability and cost of false positives and
12 false negatives kind of argument because there are
13 certainly plenty of possibility proofs that show that
14 you can have anticompetitive effects in this situation
15 even with overall price exceeding overall cost.
16 So the piece that I'm not hearing -- and maybe
17 Hovenkamp lays it out in this article, and I haven't had
18 the opportunity to read it -- is how do we know, what do
19 we know about the prevalence of false positives or the
20 prevalence of false negatives and the cost of false
21 positives and the cost of false negatives?
22 Is this situation such that you would advocate
23 an average cost, average revenue rule rather than an
24 incremental cost and incremental revenue rule?
25 MR. MEYER: For the benefit of all of us, the

1 average revenue/average cost rule is what you are
2 saying --
3 MR. TOM: What I read this proposition to say,
4 yes.
5 MR. MEYER: Divide total units by total dollars.
6 PROFESSOR MURIS: Let Dan respond.
7 PROFESSOR CRANE: I wasn't trying to defend any
8 particular measure of cost, whether it is variable cost
9 or average total cost.
10 I was simply suggesting that you should use a
11 cost-based test in all cases involving single-product
12 discounts.
13 Again, even in a classic predatory pricing case,
14 what the appropriate measure of cost should be is
15 something that there is a lot of debate over.
16 Without defending any particular cost test,
17 though, I think that the proposition is correct, that is
18 to say, whatever the appropriate measure of cost is, if
19 that cost is recouped on the overall sale to a client,
20 then the discount that created the overall sale should
21 be legal.
22 PROFESSOR MURIS: Perhaps Professor Hovenkamp
23 had some idea of long run here. It doesn't matter. If
24 you are going to apply these tests, in the short run
25 real world, you will have to separate out the variable

1 costs, I would think.

2 You can have differences in different industries
3 and how you define costs. And the airline case raises
4 lots of complex problems, I agree. But I don't think I
5 read this to say that we are talking averages total cost
6 versus average total revenue.

7 MR. TOM: Sorry for being less than clear. I
8 wasn't really addressing what kind of cost is
9 appropriate in the Brooke Group kind of situation.

10 What I was addressing was the kinds of tests
11 that have been applied in the writings on Concord Boat.

12 Do you look at the incremental sales that were
13 induced by the loyalty program and look at the revenues
14 from those incremental sales and compare it to the
15 incremental cost or do you apply a Brooke Group test
16 that says you take all of the sales, all of the revenues
17 and compare it to all of the costs for all of the sales.

18 That's all I was saying. Frankly, I don't know
19 which is the right test. I think if finding out what
20 the facts were cost free and error free, then I would
21 think this is clearly the wrong test.

22 PROFESSOR ORDOVER: If you take the Concord Boat
23 stylized example in which the challenger can go
24 profitably after a particular dealership in the view of
25 the loyalty schedule that applies to the dealership,

1 obviously there is nothing to debate anymore, right?
2 If indeed it is profitable to serve that by
3 virtue of the fact that what the incumbent is charging
4 is sufficiently above cost, whatever the right measure
5 is, then you would think the effective or efficient
6 challenger should be able to squeak under it somehow and
7 capture the sale, which is why these price-cost tests
8 make some economic sense.
9 But, again, the issue is what it is that can be
10 challenged and how much of an obstacle it is if you are
11 required to challenge just the margin.
12 MR. MEYER: If you all have a few more minutes,
13 I would like to ask one further question, taking us out
14 of the realm of safe harbors.
15 Assume that whatever safe harbor is out there is
16 not applicable, and we are now asking the question
17 should the court condemn a particular loyalty discount
18 program.
19 What sorts of business justifications or
20 efficiencies should the defendant be entitled to bring
21 forward to escape liability?
22 And, for example, perhaps it is obvious that if
23 there is a particular efficiency associated with
24 incenting a bundle, that that ought to be clearly
25 cognizable, but what about simply the lower prices that

1 are being paid by consumers in the short run or gains in
2 share that the firm realizes by making its bundle more
3 attractive to those consumers. Reactions?
4 MR. TOM: I'm not sure how we quite leapfrogged
5 from the safe harbor to the efficiency justification.
6 It seems to me we have skipped the anticompetitive step
7 in between.
8 You can fail the price-cost test, but you would
9 still want some sensible explanation of how this gives
10 the defendant power over price, how prices go up as a
11 result. And if price doesn't go up or indeed goes down,
12 then I think you never get to those efficiencies.
13 MR. MEYER: Assume a plaintiff is coming forward
14 and arguing that you are going to be excluding your only
15 competitor by pricing this way, that you won't have any
16 competition because a competitor cannot match the
17 bundled price or the program. Assume that.
18 MR. TOM: Then you may get into a debate I don't
19 like to get into about consumer welfare versus total
20 welfare, which is a little too theological for my taste
21 or at least for my knowledge.
22 So I will leave that to more expert folks.
23 MR. MEYER: What justifications can a firm offer
24 for successfully excluding its rival using some kind of
25 pricing program like this?

1 PROFESSOR CRANE: I think obviously there are
2 plenty of pro-competitive reasons, like it costs less to
3 sell the bundle. Those are obvious ones.
4 The real question would come up if the plaintiff
5 met whatever its prima facie case was and then the
6 defendant was put to the burden of responding through
7 some sort of explanation for why they offer the discount
8 package. And things like price discrimination would
9 come up.
10 To the extent that mixed bundling is explicable
11 because it is device for price discrimination, how
12 should that cut? Price discrimination could be good for
13 output. It can increase output. It can reduce output.
14 Very hard to show sort of which way that cuts.
15 So to me, any explanation that the defendant
16 could offer that's accepted as the true explanation that
17 is not an exclusionary explanation should be legitimate.
18 MR. MEYER: That sounds like a no economic sense
19 test.
20 PROFESSOR ORDOVER: It is a good one.
21 PROFESSOR CRANE: It is a pretty good one. We
22 have some support on the panel for it.
23 I think the sacrifice test or no economic sense
24 test is difficult as a starting point. When it comes to
25 defenses, it makes some sense, I think.

1 MR. MEYER: Other reactions?
2 MR. TOM: Let me just pose a question on that
3 last one.
4 I said I didn't want to get into the total
5 welfare versus consumer welfare. But I want to know if
6 that's the question you are posing.
7 You are hypothesizing that the result of this
8 conduct is that prices to consumers go up. That is,
9 whatever the efficiency justification, it doesn't lower
10 the monopolist cost sufficiently that the price actually
11 goes down. Am I correct in understanding that?
12 MR. MEYER: That's a good question. I wasn't
13 being nearly so theological.
14 MR. TOM: Go ahead.
15 PROFESSOR MURIS: There are lots of them, and I
16 prefaced them at the beginning and in the paper,
17 specific efficiency justifications one can think of to
18 stick with bundling.
19 We need to step back and realize we are in a
20 world where bundling is everywhere in very competitive
21 markets. That in itself is an enormous empirical
22 proposition of the efficiency benefits of bundling.
23 PROFESSOR ORDOVER: I think that is
24 undisputable. In fact, it is the case with many of
25 these kinds of loyalty rebates as well.

1 You go to Starbucks. You used to get your 10th
2 cup of coffee free if you bought nine. Then you have a
3 big discontinuity.
4 MR. MEYER: No one else can sell you that 10th
5 cup, right?
6 PROFESSOR ORDOVER: It makes you drink the 10th
7 cup and get jittery.
8 There are some good reasons for stimulating
9 demand, especially when you have a world in which the
10 marginal cost is really low and you want to drive
11 demand. It is a very powerful driver.
12 When you have asymmetric information between the
13 buyer and the seller or in many of these environments
14 that people talk about, the GPO is insisting on
15 discounts that are not volume driven but share driven in
16 part on this theory that the differently situated
17 hospitals are to be equally treated. And just because
18 you are a small hospital, you can only buy 10 units of
19 X, and if you are the big one, you can buy 100 units.
20 You should not be somehow disadvantaged because of that
21 because you are under the umbrella of the GPO.
22 Some people say that is silly or what. There
23 are -- if you go back to the case that was not quite
24 fully litigated, Virgin British Airways case which
25 pitted Schmazi against Bernheim, two pillars of

1 antitrust and higher economics.

2 There was a lot of discussion as to the

3 usefulness of these various mechanisms as drivers of

4 volume of sales at the travel agency level, which is

5 where much of the action was.

6 Rewinding the Areta paper by ten years, we will

7 learn a lot of what the economics was at that time.

8 Schmazi had a large number of defenses that he

9 put forth why share-driven contracts were in fact

10 efficient or optimal in some cases, and Bernheim took a

11 somewhat different legal, working for Virgin.

12 It is a case which we have not cited here, but

13 it has a lot of levity in economics.

14 MR. MEYER: We could go on forever here, but we

15 won't.

16 I want to thank everyone on the panel for an

17 excellent discussion. Thank you all for attending.

18 The next session will be next week, December

19 6th, I think, on misrepresentation and deceptive

20 practices.

21 Thank you all for coming.

22 (Whereupon, at 4:08 p.m., the hearing was

23 concluded.)

24

25

1 C E R T I F I C A T I O N O F R E P O R T E R
2 DOCKET/FILE NUMBER: P062106
3 CASE TITLE: SECTION 2 HEARING
4 DATE: NOVEMBER 29, 2006
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