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Summary of Committee Program: "Considering the Cost of The Price-Cost Test"

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On October 7, 2015, the ABA Pricing Conduct Committee presented "Considering the Cost of the Price-Cost Test," a discussion centered on the theoretical and practical advantages and weaknesses of the price-cost test in conditional pricing analyses. James Nichols, Vice Chair of the ABA Antitrust Pricing Conduct Committee, moderated the discussion between three distinguished panelists, Steven Salop, Professor of Economics and Law at Georgetown University Law Center; Daniel Crane, Professor at University of Michigan Law School; and, Jeffrey Klenk, Associate Director of Berkeley Research Group.

The use of the price-cost test in analyzing conditional pricing practices such as loyalty and bundled discounts is controversial. The Supreme Court articulated the price-cost test in the context of the predatory pricing claim in *Brooke Group, Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209 (1993) – that to succeed in making a claim of predatory pricing, the plaintiff must prove the defendant's prices are below an appropriate measure of the defendant's costs. However, real world application of this test is complicated. There is no consensus on how to analyze the antitrust implications of these discounting practices. Many high profile antitrust cases litigated on this issue have been heard by the Third Circuit, including *LePage's Inc. v. 3M Co.*, 324 F.3d 141 (3d Cir. 2003), and recently *ZF Meritor, LLC v. Eaton Corp.*, 696 F.3d 254 (3d Cir. 2012). In addition, the Third Circuit will likely soon release an opinion in a case involving loyalty discounts, *Eisai Inc. v. Sanofi-Aventis U.S., LLC*, No. 08-4168 (MLC), 2014 U.S. Dist. LEXIS 46791 (D.N.J., Mar. 28, 2014).

Under the *Brooke Group* conceptual framework, Mr. Klenk explained, the intent of the price-cost test is to determine whether the effect of a dominant firm's pricing is to exclude an equally efficient rival from competing. Historically, the price-cost test has applied to below cost predatory pricing claims, in which courts looked to see if the dominant firm's price for a product was below the cost of selling or producing that product.

More recently, the test has been applied to a wider array of pricing conduct, including bundled and loyalty discounts and market share discounts. Under these circumstances, the test has evolved to applying all relevant discounts to the price of the incremental unit—the unit that triggers the market share or other discount—and comparing that fully discounted price to the cost of producing the incremental unit. This methodology, the discount attribution test, was adopted by the Ninth Circuit in *Cascade Health Solutions v. PeaceHealth*, 515 F.3d 883 (9th Cir. 2008). The Ninth Circuit's decision in *PeaceHealth* created a circuit split as it rejected the Third Circuit's holding in *LePage's*, which adopted an exclusionary effects test.

The panelists debated whether the price-cost test should be applied more broadly to other pricing conduct. Arguing in favor of the price-cost test, Prof. Crane stated that if loyalty discounts simply require a rival to lower prices then there is no foreclosure. Loyalty discounts only lead to exclusionary conduct when the discount substantially forecloses a competitor from competing for the business. According to Prof. Crane, such a claim requires proof that the competitor would have to price unprofitably. Loyalty discounts can be highly beneficial to consumers. As support, Prof. Crane referenced many consumers' preference for loyalty discounts over volume discounts. For example, small customers can qualify for loyalty discounts even if they do not have the necessary volume; even large customers prefer loyalty over volume discounts because they can eliminate the risk of fluctuating demand. In fact, group purchasing organizations, which are buyer collectives that leverage their buying power, often are the ones initiating requests for loyalty discounts. This, according to Prof. Crane, is prima facie evidence that loyalty discounts can be beneficial to consumers, though he did acknowledge the risk of collective action problems.

In contrast, Prof. Salop believes that the price-cost test should not apply to alleged exclusionary loyalty discounts; instead, counsel should undertake a traditional anticompetitive effects analysis: Will a rival's costs rise materially? Does the defendant gain power over price? Is there sufficient competition from non-foreclosed firms? Are there sufficient cognizable efficiency benefits? Counsel should look at the foreclosure rate and the likely harm to competition as it is not the price that is the problem, but the condition that a customer cannot buy from a new entrant.

In Prof. Salop's opinion, the price-cost test should be eliminated because it is prone to errors which can lead to false positives and negatives. For example, even if the incremental price is below the incremental cost, there might not be sufficient foreclosure (e.g., a discount given to only one customer will not deter entry) or competitive harm (e.g., sufficient non-excluded competitors may prevent a firm from raising prices). Worse, sometimes a price discount actually disguises a price penalty, an example of a false negative. Imagine a monopolist charges a monopoly price of $100. Upon entry of a new firm, the monopolist may choose to charge distributors $120 if they use both the new entrant and itself, or $100 if the distributors work exclusively with the monopolist. According to Prof. Salop, what looks like a discount of $20 for exclusivity is in fact a true tax on nonexclusivity. The problem associated with false negatives is that bidding does not occur on a level playing field. For example, an entrant may face a collective action coordination problem wherein the entrant typically needs multiple distributors but will not be able to convince a distributor to agree to forego a discount from the dominant firm unless the distributor thinks other firms will join as well. As another example, there might not be any bidding at all, leaving an entrant unable to counterbid.

Mr. Klenk discussed the real world limitations of applying the price-cost test. In his view, even if the price-cost test is assumed to have probative value, the results of the test are nevertheless not dispositive. Three components of the test—price, cost, and the contestable unit—are all subject to much debate and require intense analysis. The problems and inquiries related to the evaluation of costs provides a probative example.

Economists often find that the necessary cost data is not available, even from large Fortune 500 companies, as companies often do not track profits and costs in a way susceptible to analysis under a price-cost test, nor at the level of granularity required, typically at the product by product level. As such, economists often need to estimate relevant cost data, which leads to regression analyses and the necessity of determining underlying assumptions, all of which are subject to reasonable challenges.

In addition, economists must determine what relevant costs to consider. Though the price-cost test instructs that incremental costs are relevant, does that mean marginal cost calculations are required, or are average variable costs an adequate substitute? Marginal costs are difficult to determine and unlike average variable costs, may fail to incorporate certain relevant costs that are not captured in the production of the last incremental unit (e.g., inputs that decay over months or years before needing to be replaced). Further, are relevant costs only cash outlays or do accounting costs like depreciation and interest expense count as well? Accounting costs are not captured in a marginal cost analysis and yet, machines wear down over time and require replacement. Moreover, teasing out the variable components of costs is challenging (e.g., some portion of utility costs at plants are often fixed) and again require regression analyses subject to major pitfalls.

Mr. Klenk also explained that focusing on marginal costs may even be misleading in industries like pharmaceuticals and software where nominal incremental costs (e.g., the cost to manufacture one more pill or copy one more CD) belie enormous costs of research and development and large manufacturing facilities. In these industries, the price-cost test loses its relevance because companies need to price above marginal cost to recoup their previously incurred large sunk costs.

However, according to Mr. Klenk, the real world limitations of the price-cost test also apply to foreclosure and other alternative price-cost tests. Prof. Salop argued this is precisely why rule of reason is the test to determine anticompetitive effects. The price-cost test at most measures intent, not effects and therefore is inappropriate for application in antitrust law. Instead, actual anticompetitive effects should be measured.

The panel briefly turned to whether there are practical advantages to applying the price-cost test, such as ease of administration and ease of advising clients. Though Prof. Crane agreed that lack of ease of administration is a fair criticism of the price-cost test, he maintains that it is helpful in thinking through what kinds of incentive structures firms can use. Prof. Salop agreed with Mr. Klenk's statements that application of the price-cost test is deceptively simple, particularly in the loyalty discount arena. Whereas in predatory pricing instances, everyone faces the same prices, in the loyalty discount context, every customer has a different price so it is much more difficult to analyze how much a customer would have bought in the but for world without the discount. He recommended instead that counsel base their advice on the assumption that the client's conditional pricing scheme will lead to exclusive or near-exclusive dealing, and examine the anticompetitive effects under that framework. Mr. Klenk advised that counsel inquire as to the reason for implementing a loyalty discount (e.g., to lower consumer costs, to foreclose competition, to exclude potential rivals). Prof. Crane was hesitant to base a claim on intent as corporate intent is difficult to determine. In his opinion, counsel should apply the price-cost test as it measures whether rivals can compete and whether there is an anticompetitive effect.

The last segment of the discussion briefly touched on how the price-cost test could minimize the risk of opportunistic litigation driven by *LePage's*. In *LePage's*, Prof. Crane argued, the plaintiff was able to reach the jury on a foreclosure theory without any objective evidence that it was unable to compete for business. Prof. Crane believes the price-cost test is important for disciplining plaintiffs as the test requires plaintiffs to provide objective evidence of a threshold level of exclusion at the motion to dismiss stage.

About the Author

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Call for Articles*. The Price Point is seeking submissions for our next issue. Consistent with the Pricing Conduct Committee's focus, articles on price discrimination and Robinson-Patman Act issues, resale price maintenance, predatory pricing, bundled pricing, volume and loyalty discounts, price squeezes, or other pricing-related topics are welcome. Articles should be approximately 2,000 words in length, excluding notes.* ***Submissions are due by Feb. 15, 2016***