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# **An Evidence-Based Approach to Exclusive Dealing and Loyalty Discounts**

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## An Evidence-Based Approach to Exclusive Dealing and Loyalty Discounts

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The primary anticompetitive concern with exclusive dealing contracts is that a monopolist might utilize exclusivity to fortify its market position, raise rivals' costs of distribution, and ultimately harm consumers. The unifying economic logic of these anticompetitive models of exclusivity is that the potential entrant (or current rival) could, absent the exclusive contracts, attract a sufficient mass of retailers to cover its fixed costs of entry, but that the monopolist's contracts with retailers prevent the potential entrant from doing so. However, the exclusionary equilibrium in these models is relatively fragile, and the models often generate multiple equilibria in which buyers reject exclusivity arrangements. At a recent set of hearings on antitrust analysis of exclusive dealing contracts, a sensible consensus view emerged that a necessary condition for anticompetitive harm in an exclusive dealing or *de facto* exclusive contract is that the contract deprives rivals of the opportunity to compete. These contracts, including market-share discounts and "loyalty discounts," can harm competition when they deprive rivals of an entrenched firm from accessing distribution sufficient to achieve a minimum efficient scale. The recently-withdrawn Section 2 Report reflects this consensus:

In particular, exclusive dealing may be harmful when it deprives rivals "of the necessary scale to achieve efficiencies, even though, absent the exclusivity," more than one firm "would . . . be large enough to achieve efficiency." In other words, exclusive dealing can be a way that a firm acquires or maintains monopoly power by impairing the ability of rivals to grow into effective competitors that erode the firm's position. As one panelist put it, "the exclusive dealing case that you ought to worry about" is where exclusivity deprives rivals of the ability to obtain economies of

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scale.<sup>2</sup>

The Report also goes on to note the pro-competitive justifications for exclusive dealing. These justifications range from the variety of ways in which exclusive dealing can prevent free-riding and facilitate relationship-specific investments to intensifying manufacturer competition for scarce retailer shelf space or distribution, with the benefits of that intensified competition passed on to consumers.

The situation antitrust enforcers find themselves in with respect to exclusive dealing is familiar. On the one hand, there are a set of possibility theorems which indicate that exclusive dealing and *de facto* exclusive contracts can lead to anticompetitive outcomes under some specified conditions, including substantial economies of scale or scope. On the other, there are a set of sensible and economically rigorous pro-competitive justifications for the practice. Reinforcing this conflict is the casual empiricism that we observe exclusive dealing contracts in competitive markets and adopted by firms without significant market power. As David Evans has noted, quite a bit can be learned about the relative probabilities of anticompetitive and pro-competitive uses of certain types of business behavior by understanding their incidence of use by competitive firms.<sup>3</sup> Exclusive dealing is no different. The primary economic challenge to designing efficient competition standards to govern exclusive dealing contracts is a “model selection” problem.

The standard error cost approach to this problem is to turn to the evidence to ensure that liability rules do not needlessly harm consumers by over-detering pro-competitive conduct or under-detering anticompetitive conduct. What, then, is known about the incidences of anticompetitive exclusive dealing and *de facto* exclusive dealing contracts? The question is not one of the logical validity of any of the competing theories: the *possibility* of anticompetitive effect from exclusive dealing arrangements is well established as a matter of economic theory. The question, rather, is whether these theories describe an empirical phenomenon of relevance in forming antitrust policy. A sensible approach to designing antitrust liability rules for exclusive dealing would be to design a conduct-specific standard sensitive to the particular relative risks of Type I and Type II errors informed by the best available existing evidence. While more evidence is always better, and there is certainly a need for more empirical research about single firm conduct, the limited nature of the evidence does not mean scholars and policymakers have zero information with which to update prior assumptions on the underlying policy question.

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<sup>2</sup> U.S. DEP’T. OF JUSTICE, COMPETITION AND MONOPOLY: SINGLE-FIRM CONDUCT UNDER SECTION 2 OF THE SHERMAN ACT 137 (2008), available at <http://www.usdoj.gov/atr/public/reports/236681.pdf> (internal citations omitted).

<sup>3</sup> See, e.g., David S. Evans and A. Jorge Padilla, *Designing Antitrust Rules for Assessing Unilateral Practices: A Neo-Chicago Approach*, 72 U. CHI. L. REV. 73 (2005).

Such an examination necessarily starts with the existing evidence. While empirical evidence on exclusive dealing contracts' competitive consequences is scarce, the evidence is not insignificant. Indeed, even relative to other types of vertical restraints such as resale price maintenance (or RPM), the evidence substantially supports the view that exclusive dealing is much more likely to be pro-competitive than anticompetitive. For instance, Heide et al. conducted a survey of managers responsible for distribution decisions and found a correlation between the incidence of exclusive dealing contracts and the ability of rivals to free-ride on contracting firm investments.<sup>4</sup> Both Asker and Sass separately examined the welfare consequences of exclusive dealing in the beer market by observing the effect of exclusive dealing on total market output, as well as the output and prices of rival distributors, concluding that exclusive dealing is output increasing and does not generate foreclosure.<sup>5</sup> I provide evidence in another piece that restrictive shelf space contracts are not associated with anticompetitive effects.<sup>6</sup> Finally, Lafontaine and Slade's survey of exclusive dealing contracts and vertical integration concludes that the practices are generally efficient and not associated with anticompetitive outcomes.<sup>7</sup> After their own detailed and comprehensive review of the existing empirical evidence, Lafontaine and Slade conclude that:

In general then, the empirical evidence leads one to conclude that consumer well being tends to be congruent with manufacturer profits, at least with respect to the voluntary adoption of vertical restraints. When the government intervenes and forces firms to adopt (or discontinue the use of) vertical restraints, in contrast, it tends to make consumers worse off.

It is important to note the limits of what the empirical evidence demonstrates. The empirical evidence does not conclusively show that exclusive dealing is always or only pro-competitive. It does, however, show that there is relatively little support for recently expounded anticompetitive theories and relatively greater support for the conventional, pro-competitive view of exclusive dealing contracts. While further empirical research on exclusive dealing contracts and their competitive consequences is

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<sup>4</sup> Jan B. Heide et al., *Exclusive Dealing and Business Efficiency: Evidence from Industry Practice*, 41 J.L. & ECON. 387 (1988).

<sup>5</sup> Tim R. Sass, *The Competitive Effects of Exclusive Dealing: Evidence from the U.S. Beer Industry*, 23 INT'L J. INDUS. ORG. 203 (2005); John Asker, *Diagnosing Foreclosure Due to Exclusive Dealing* (unpublished working paper, 2004).

<sup>6</sup> Joshua D. Wright, *Slotting Contracts and Consumer Welfare*, 74 ANTITRUST L. J. 439 (2007). See also Alden F. Abbott and Joshua D. Wright, *Antitrust Analysis of Tying Arrangements and Exclusive Dealing*, in ANTITRUST LAW AND ECONOMICS (Keith N. Hylton, ed., forthcoming 2009), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1145529](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1145529) (summarizing the empirical evidence on exclusive dealings contracts).

<sup>7</sup> Francine Lafontaine and Margaret Slade, *Exclusive Contracts and Vertical Restraints: Empirical Evidence and Public Policy*, in HANDBOOK OF ANTITRUST ECONOMICS (Paolo Buccirossi, ed., forthcoming 2009), available at <http://www2.warwick.ac.uk/fac/soc/economics/staff/faculty/slade/wp/ecsept2005.pdf>; see also James C. Cooper et al., *Vertical Antitrust Policy as a Problem of Interference*, 23 INT'L J. INDUS. ORG. 639 (2005), available at <http://www.ftc.gov/speeches/froeb/050218verticalecon.pdf>.

needed, application of the evidence-based antitrust approach relying on existing theory and evidence suggests that the anticompetitive models supporting more interventionist approaches to exclusive contracts should not form the basis of antitrust policy.

What antitrust analysis does the empirical evidence suggest under the error-cost approach? Ideal error-cost informed standards would reflect the best estimates of the incidence of anticompetitive exclusive dealing and the relative social costs associated with Type I and Type II errors in this setting, and would incorporate safe harbors for conduct that we know is unlikely to generate competitive harms. In this case, the evidence suggests that the probable incidence of anticompetitive exclusive dealing is low and the incidence of pro-competitive exclusive dealing (and in competitive markets) is high. The evidence and experience also demonstrate that payments for exclusivity at the retail level are likely to be passed on to consumers in competitive retail markets, implying that the social costs of false positives in this case must account for the loss of welfare-increasing competition. Relying on the theoretical literature, we further observe that the only conditions under which exclusive dealing can lead to anticompetitive outcomes are where (1) there is substantial foreclosure of a market, (2) rivals do not have access to compete for distribution, and (3) thus are at risk of being cut off from distribution in a way that (4) deprives them of the opportunity to achieve minimum efficient scale.

The error cost approach leads to at least two clear policy recommendations. The first is a safe harbor for foreclosure levels of less than 40 percent of the relevant market. Similarly, the second is a safe harbor for exclusive dealing contracts that are terminable in one year or less. The Department of Justice, relying on its experience in *Dentsply*, has backed away from endorsing this second safe harbor policy. To their credit, however, the Department of Justice does provide a foreclosure safe harbor — or at least indicates that exclusive dealing contracts that foreclose less than 30 percent of the market should not be illegal. This is consistent with the necessary (but not sufficient) conditions of the anticompetitive theories, and a sensible start to an evidence-based approach. While the appropriate range for this “safe harbor” provision is potentially broad depending on one’s reading of the applicable case law, the Department’s position, though at the low end of the range, is nonetheless quite defensible. The central consideration, regardless of the exact percentage, is that such a safe harbor must be based on sound economic theory adequately supported by empirical evidence. This analysis could be further refined by empirical research into precisely the level of foreclosure at which competitive harm becomes an issue; however, the Department rule is a good starting point, and provides some much-needed guidance for broad classes of distribution arrangements that will not be challenged by antitrust regulatory agencies.

As a final, related word, it should be noted that the anticompetitive theories of

harm for loyalty discounts often are identical to or analytically approximate the claims in exclusive dealing cases. Specifically, the anticompetitive hypothesis condemning loyalty discounts is that such distribution contracts result in a form of *de facto* exclusivity that deprives a potential rival of an opportunity to compete for distribution sufficient to achieve the minimum efficient scale. The key observations from an evidence-based perspective, however, are twofold: first, there is little to no empirical evidence that loyalty discounts lead to anticompetitive outcomes, and second, loyalty discounts are passed on to consumers, and thereby increase consumer welfare. Like exclusive dealing, the sparse empirical data, read in conjunction with actually observed consumer gains, ought to lead to a liability rule that places a strong burden on a plaintiff to demonstrate *actual* competitive harm. Furthermore, as with exclusive dealing, this state should lead to safe harbor provisions based on sound theory and evidence where such harbors can reasonably be crafted. In this case, since all applicable anticompetitive theories require foreclosure of a significant share of distribution as well as substantial economies of scale, logic dictates a safe harbor in loyalty discount cases for defendants based on foreclosure of less than a pre-specified share of the relevant market. The right starting point for such a safe harbor comes, of course, from the cases, and could be set, amongst other points, at 40 percent. Building on the DOJ's analysis, however, an argument can and should be made that the exclusive dealing safe harbor (for less than 30% foreclosure) logically can and should apply to loyalty discounts as well.<sup>8</sup> Above all else, the important policy point is to economize on existing evidence to design standards that minimize the sum of error and administrative costs and maximize consumer gains.

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<sup>8</sup> For two papers arguing for cost-based safe harbor provisions in this context, see Daniel A. Crane, *Mixed Bundling, Profit Sacrifice, and Consumer Welfare*, 55 EMORY L.J. 423 (2006); Thomas A. Lambert, *Evaluating Bundled Discounts*, 89 MINN. L. REV. 1688 (2005).