BATES WHITE
ECONOMIC CONSULTING

Counseling clients on exclusionary conduct: Lessons from *AMD v. Intel*

New York State Bar Association, Antitrust Section

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Introductions

- George Rozanski, PhD, Partner
  - Former Chief of the Economic Regulatory Section of the Antitrust Division of DOJ
  - Specializes in antitrust analysis of horizontal and vertical mergers, single-firm conduct, vertical restraints, and horizontal agreements
- T. Scott Thompson, PhD, Partner
  - Previously Staff Economist and Assistant Chief of the Economic Regulatory Section of the Antitrust Division of DOJ
  - Specializes in analysis of mergers, single-firm conduct, vertical restraints, horizontal agreements, and econometrics
- Randal Heeb, PhD, Partner
  - Senior Faculty Fellow at Yale School of Management
  - Specializes in antitrust and intellectual property issues, especially in innovation intensive industries

Bates White—firm overview

- Founded in 1999 by academic econometrician Hal White and testifying expert Charley Bates
- Named to GCR's listing of the world's top 20 firms in competition economics
- Offers a broad portfolio of services in economics, finance, and litigation support
- More than 150 professionals from diverse academic backgrounds with offices in Washington, DC and San Diego, CA
- International partnership with ESMT Competition Analysis in Berlin
  - Dr. Lars-Hendrik Röller, President of European School of Management and Technology and former Chief Competition Economist, European Commission
  - http://www.esmt.org/eng/consulting/about-esmt-competition-analysis/

Selected affiliated academic economists—antitrust practice

- **B. Douglas Bernheim, PhD (Partner)**
  - Stanford University
  - Econometrics, antitrust
- **Greg Crawford, PhD**
  - University of Warwick, United Kingdom
  - Former FCC Chief Economist
- **David Dranove, PhD**
  - Kellogg School, Northwestern University
  - Healthcare and health insurance markets
- **Robert Marshall, PhD (Partner)**
  - Penn State University
  - Econometrics, antitrust
- **Aviv Nevo, PhD**
  - Northwestern University
  - Econometrics, antitrust
- **Leslie Marx, PhD (Partner)**
  - Duke University
  - Former FCC Chief Economist, antitrust
- **Ariel Pakes, PhD**
  - Harvard University
  - Econometrics, antitrust, intellectual property
- **Martin K. Perry, PhD, JD**
  - Rutgers University
  - Former FCC Chief Economist, antitrust
- **Tomas Philipson, PhD**
  - University of Chicago Harris School
  - Healthcare markets
- **Marius Schwartz, PhD**
  - Georgetown University
  - Former Acting Deputy AAG, Antirust Division
- **James Stock, PhD**
  - Harvard University
  - Econometrics, economic damages
- **Mark Watson, PhD**
  - Princeton University
  - Econometrics, economic damages
- **Michael Whinston, PhD**
  - Northwestern University
  - Antitrust
- **Halbert White, PhD (Founding Partner)**
  - University of California at San Diego
  - Econometrics, economic damages

Agenda

- *AMD v. Intel*—the conduct at issue*
- Classifying potentially exclusionary conduct
  - Predation vs. conditionality
  - Sorting out procompetitive and anticompetitive conditions
- Counseling clients
  - Levels of risk—how safe is that harbor?
  - Questions to ask your clients to learn if there is antitrust risk
  - Minimizing risk from antitrust concerns

***** – Bates White supported three academic experts offering testimony on behalf of AMD in this litigation. Characterizations of conduct made here are based on allegations in public documents.

Examples from *AMD v. Intel*: Allegations of conditions or contracts that attracted scrutiny

- Volume discounts conditional on large share of purchases
  - 100% becomes an exclusive deal
- Large quantities required to obtain discounts imply or require exclusivity
  - Partial exclusivity by segment
  - 95% share of an OEM's commercial desktop sales
- Conditional rebates and marketing support
  - Restrictions on an OEM's marketing of rival's products to corporate customers
  - Restrictions on branding and promotion of rival's servers
- Implied or explicit threats of future retaliation for dealing with rivals
  - Rebates and lump-sum payments important for OEMs
- Contracts are informal, based on understanding between parties

Distinguishing types of potentially exclusionary conduct

- Winning a sale from a rival “excludes” the rival from that sale
  - This alone cannot be what we mean by “exclusionary conduct”
- Two types of potentially exclusionary conduct
  - Predatory conduct
    - Including certain kinds of loyalty, volume or bundled discounts
  - Conditions or restrictions on the customer’s dealings with rivals
    - Including exclusive dealing, partial exclusivity, rebates or payments in exchange for exclusivity, etc.
- These two types of conduct have different implications for
  - The mechanism of exclusion
  - Impact on customers and consumers
  - Public policy
  - Appropriate tests
- Exclusion is not necessarily anticompetitive

Predatory conduct

- Predatory conduct involves winning sales the firm would not pursue but for their effect on rivals
  - Canonical example: pricing at or below cost to induce exit
- Difficult to distinguish from ordinary competition
  - Aggressive enforcement risks chilling competition
- Variety of tests for pricing below cost have been proposed
  - Sometimes proposed as legal safe harbor—not derived rigorously from economics
    - Pricing below some appropriate measure of cost is neither necessary nor sufficient to establish exclusionary effects or harm to competition
  - Needs careful implementation for complex pricing arrangements such as bundled discounts
  - Appropriate cost measure may depend on circumstances

Exclusive dealing and other conditions on dealings with a rival

- Conditions that restrict a customer's dealings with a rival may have exclusionary effects
- These conditions do not resemble 'ordinary' competition
  - Conditions are redundant when the objective is only to win the current sale
- The effect may be to weaken a rival or reduce competition for other sales
- There are procompetitive reasons for some conditions or restrictions
  - Must distinguish procompetitive and anticompetitive mechanisms and implications

Mechanisms by which conditions might be anticompetitive

- Loyalty discounts may implement a predatory pricing mechanism
- Full or partial exclusivity may close the market to rivals
  - More problematic if foreclosed channels are more important
- Restrictions on dealing with rivals may weaken rivals
  - Prevent development of customer relationships
  - Inhibit customer acceptance
  - Reduce learning by doing
  - Deny access to economies of scope or scale
  - Financially weaken a rival
- Anticompetitive theory must explain why customer accepts terms
  - Customer may benefit at the expense of final consumers, its competitors and/or the rival
  - Customer might be coerced
  - Customer may be indifferent because harm is largely passed on to final consumers

Conditions may also enhance competition

- Exclusivity itself can be procompetitive
  - Canonical example: prevent free riding or promote customer service
- Exclusivity or other conditions may be required to facilitate optimal investment
  - Investment by manufacturer in customer-specific innovation might not pay off unless downstream partner is locked in with exclusivity
  - Incentivize customer to take procompetitive actions

Counseling clients—market power screen

- Market power: a firm without market power faces little risk
- Factors to consider
  - Degree of pricing power
  - Market share
  - Barriers to entry
  - Existence of ‘must-carry’ products
  - Be alert to alternative market definitions
    - Client business managers may focus on competition in broader or narrower market segments than rival’s managers
    - To identify risks, consider market power from rival’s perspective

Counseling clients—antitrust risk from conditions imposed on customers' dealing with rivals

- No risk—no conditions or threats
- Low risk—conditions do not significantly impede rivals
- Low risk—conditions accomplish clear procompetitive objective
- Low risk—conditions are least onerous imposition on rivals to accomplish procompetitive objective
- More risk—conditions appear to be primarily aimed at weakening rivals
- More risk—conditions include implied threat of future retaliation
- More risk—conditions expressed as share of customer's business
- More risk—failing to accept terms threatens customer's ability to remain competitive in its market

Counseling clients—antitrust risk from price setting

- No risk—price above average total cost without conditions
- Low risk—price above marginal cost but below average total cost without conditions
  - Little or no risk except in high fixed-cost businesses
- More risk—significant share requirements to obtain discounts
  - Volume discounts with large volumes might be effectively share contracts
- High risk—price below marginal cost
- Volume discounts or rebates can be ‘stepped’ to avoid attributed rebates creating a below-cost portion of the price schedule
- Bundling requires attributed discount test (PeaceHealth)
- Volume discounts with ‘must carry’ products might be treated as bundled discount

Role of intent

- Intent may or may not be an element of proof of anticompetitive conduct, but it can help to identify problematic behavior in advance
- Business executives might not characterize the reasons why contract terms are effective or necessary as procompetitive or anticompetitive, but they typically can answer questions that identify both intent and the competitive mechanism
  - Why is a given practice effective?

Questions for business people: why this contract?

- What will happen if an exclusivity condition is not imposed?
- Responses that generate less concern:
  - Our marketing funds or efforts will be diverted to help rivals
  - Rival will directly benefit from our investment
    - Best answer: our investment only makes sense if condition is in place
  - We would be unable to charge higher prices to high-value customers (price discrimination)
- Responses that generate some concern:
  - Customer will not have enough incentive to buy our product
  - Customer would structure its investments in ways that advantage rival
- Responses that generate more concern:
  - Rival will gain valuable traction, experience, relationships, etc. that will make the rival a more formidable competitor in the future

More questions: What is the long-run effect on competition?

- Less concern if:
  - Competition will be vigorous because…
  - Customers or final consumers will be better off because…
- Some concern if:
  - Effect on customers or competition is mixed, some will be worse off and some better off
  - Customers might pay higher prices but will get higher quality
  - Rival will continue to succeed, but only in its current niches
  - Competition may be reduced because we've improved our relative value proposition
- More concern if:
  - Competition may be reduced because rivals will be weaker
  - Rivals will not be able to compete as well in the future
  - We will have more ability to control price and drive sales volume

Other elements of counseling on competition

- Capture the business documents that demonstrate the procompetitive justifications for restrictive agreements
- Educate line managers about high-risk practices
  - E.g., Avoid threatening the customer with retaliation for doing business with a rival
- Periodically assess risks associated with degree of market power attained in important product markets

Counseling clients—call your antitrust counsel if…

- Marginal prices on any part of the price schedule are below cost
- Contract terms are explicitly conditioned on customer's business with rivals
  - Including terms that reference client's share of the customer's business—such terms implicitly depend on rivals' share
- Contract terms are implicitly conditioned on customer's business with rival
- Future relations with customers are conditioned on customer's business with rival

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