

The strategic uses of price discrimination

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Pros and Cons of Price Discrimination

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What you will not hear this morning

(at least not from me)

- Price discrimination may be pro- or anticompetitive depending on the circumstances
- If only Economists could be left alone and deal with it on a case-by-case basis (pure rule of reason), they would get things right
- Rather
 - Take into account the possibility and costs of errors
 - Need for some predictability
 - Question: when is a specific rule warranted, and which one?

Introduction

- General focus of Article 82: exclusionary abuses
- We know that price discrimination may
 - Increase welfare
 - Decrease welfare without any exclusionary effect
 - Be part of an exclusionary strategy
- Easterbrook's error cost framework: the risks and costs of misinterpreting price discrimination must be accounted for when designing rules.
- The strategic uses of *non-discrimination* must also be taken into account.

Everything on a single slide

- Focus on three possible exclusionary uses of price discrimination
 - Facilitating predatory pricing
 - Facilitating exclusion through exclusive contracts
 - Raising rivals' costs (vertically integrated firms)
- No need for a specific rule for the first two categories
 - Large probability of error (observational equivalence)
 - Current tools for the handling of predatory strategies are perfectly suited to handle discrimination.
- Possible need for a rule in the case of integrated firms
 - Conflates with the essential facilities doctrine
- Large costs of ban on discrimination
 - Facilitates the exercise of monopoly power in wholesale markets
- General conclusion: little justification for a specific rule
 - Even less for "secondary line injury" cases

A thrifty predator's dream

- An incumbent faces entry on a fraction $x < 1$ of its market.
- Can induce exit with no re-entry ever by offering low price \underline{p} to the entrant's customers
 - Long term gain (monopoly power) $G(\underline{p}) > 0$
 - Short term loss $L(\underline{p}) < 0$
 - Predation is worthwhile if $G(\underline{p}) > L(\underline{p})$
- Discrimination allows to target the entrant's customers, the loss becomes $xL(\underline{p})$
 - With discrimination, predation is worthwhile as soon as $G(\underline{p}) > xL(\underline{p})$

Discrimination and predation: implications

- Discrimination can make predatory pricing more profitable, thus more frequent.
- Adding insult to injury
 - when predatory pricing happens, consumers do not even reap as much in the short term as they would under a ban on discrimination.
- This might seem to warrant a tough treatment...
 - but this conclusion is wrong, for two reasons.

Risk of error: observational equivalence

- Allowing firms to cut prices for rivals' customers is likely to lower equilibrium prices for everybody
 - Hotelling example
 - without discrimination, price is $c+t$,
 - with discrimination, price is between c and $c+t$.
- Even true if discrimination risks deterring entry
 - Armstrong and Vickers, 1993: discriminatory limit pricing is likely to increase welfare (risk of excessive entry)

Much ado about nothing?

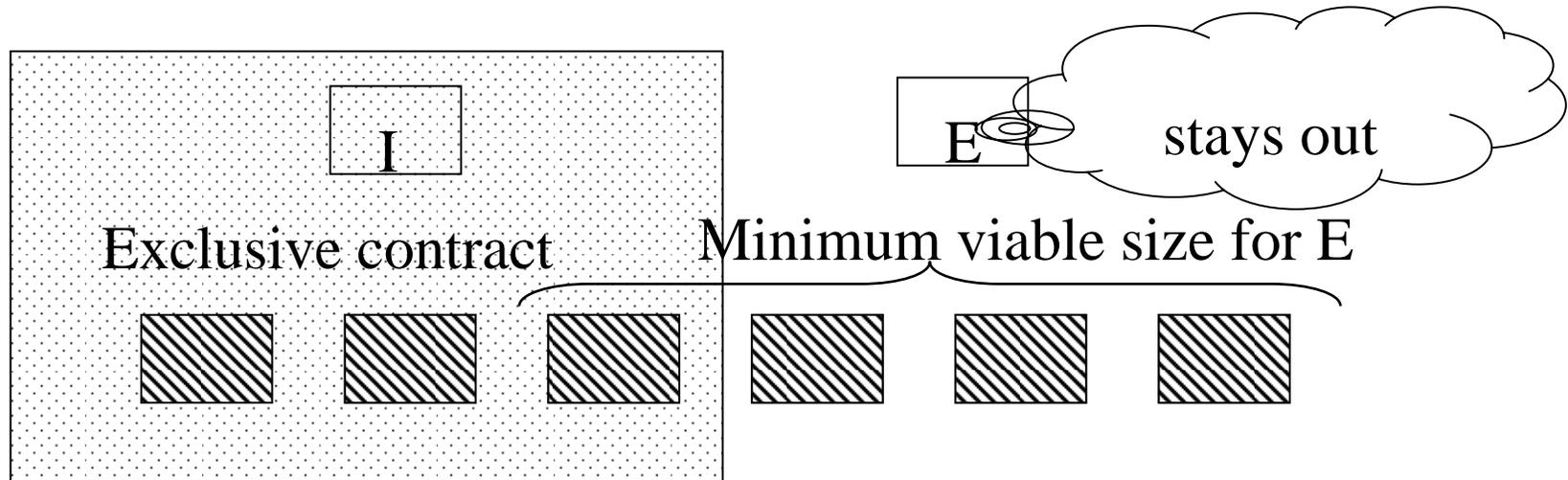
- The existing rules can "automatically" be adjusted to handle discrimination.
- Areeda-Turner or Akzo price-cost test
 - Criticized, but still there, at least as a safe harbor.
 - If there is discrimination, test should be applied customer per customer
 - Problem: handling of common fixed costs / Ramsey pricing
- *Brooke group* test (role of recoupment)
 - The analysis of recoupment possibilities is bound to compare the likelihood and magnitude of post-eviction profits with pre-eviction losses caused by low prices
 - In the case of discrimination, the test is automatically tilted toward detecting predation more often.

Discrimination as a response to the Chicago critique

- Chicago critique of the claim that exclusive contracts can be anticompetitive
 - The excluding firm would have to compensate its customer for the prospect of falling prey to its monopoly power
- This argument loses its bite if
 - Discrimination is possible and
 - The excluded firm's fixed costs imply the existence of an externality across customers

RASMUSEN RAMSEYER WILEY 1991: variant 1

SEGAL WHINSTON 1998



- Neither formal exclusivity clauses nor explicit discrimination is needed (nonlinear pricing)
- But this still does not justify an outright ban...

Factors against an outright ban

- Exclusivity may be caused by pro-competitive motives (incentive provision)
 - Which apply to some customers only, hence discrimination
- The most efficient "structured rule of reason" for pricing practices should probably consider first whether market structure permits profitable eviction
 - Are the plaintiff's fixed costs large?
 - Is a partial or total exit decision
 - A likely consequence of a possible fall in market share?
 - Enough to cause the defendant to raise price?

Raising rivals' costs

- Upstream and downstream duopoly (U1,U2,D1,D2).
- A U1-D1 merger allows U2 to charge a high price to D2, thus relaxing the competitive pressure on D1 (Ordover Saloner Salop 1990).
- As such, no use for discrimination as all prices are internal transfer prices for the U1-D1 pair.
- Things change in the case of partial ownership.
- Discriminating against non-integrated downstream rivals may thus be anticompetitive
- Caveats
 - Need not to discourage vertical mergers driven by the elimination of double marginalization
 - Conflates with the essential facilities doctrine: is it sufficient?

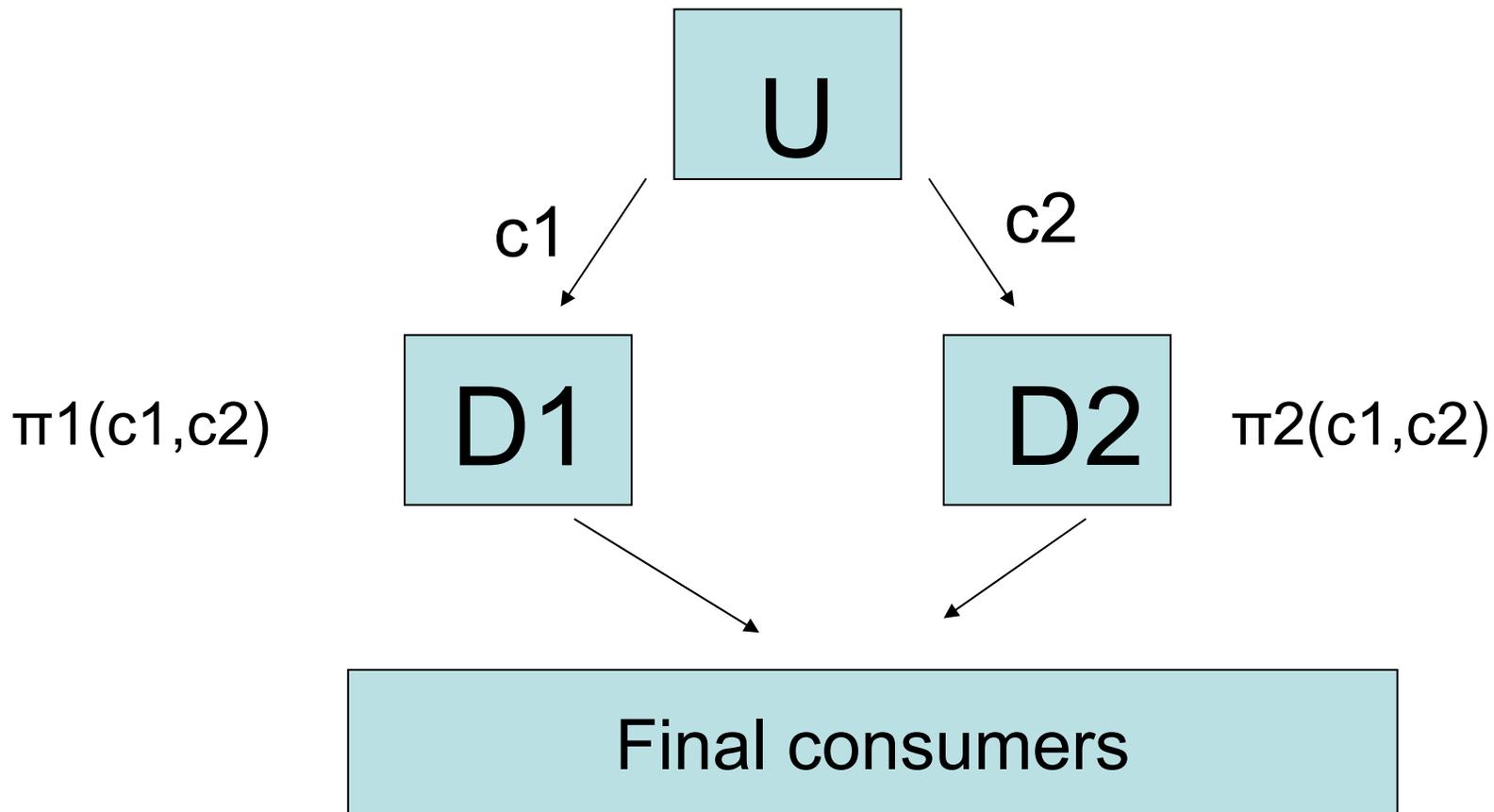
The strategic uses of non-discrimination

Example 1: solving the durable monopolist's woes

- A durable monopolist's inability to commit not to cut price with time may force it to cut price to start with.
- A ban on discrimination would remove this problem.
- Example: two periods, unit demand, uniform distribution of willingness to pay on $(0, 1)$ in each period.
 - With discrimination, price is 0.9, then 0.3.
 - With a ban on discrimination, it is 1 all the time.

The strategic uses of non-discrimination

Example 2: customers competing against each other



The strategic uses of non-discrimination

A ban on discrimination would reduce retailers' incentive to ask for low prices

- Assume that $\pi_i(c_1, c_2)$ only depends on $c_1 - c_2$
- With a ban on discrimination, no retailer has any reason to ask for a price cut, nor does a coalition of retailers.
- Absent any ban, each retailer asks for wholesale price cuts in its bilateral negotiations.
 - In equilibrium, wholesale and retail prices are lower.
- This type of analysis carries over to the situation where nonlinear wholesale pricing is feasible
 - Absent a ban, the wholesale variable price resulting from bilateral negotiations is the wholesaler's variable cost
 - with a ban, it is the one maximizing industry profits.

CONCLUSIONS

- Little support for a ban except in the case of vertically integrated firms
 - But even then: isn't the essential facilities doctrine enough?
- The adverse effects of a ban are more acute when customers compete against each other
 - Argument further reinforced by the fact that the use of "divide and conquer" strategies to deter entry is less efficient in these contexts (Motta and Fumagalli)
 - Ironic: the wording of Article 82(c) precisely refers to the idea of secondary line injury...
 - ... and so do some excellent legal scholars!