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# ROUNDTABLE ON "PRICE DISCRIMINATION"

**--Note by the United States--**

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*More documents related to this discussion can be found at www.oecd.org/daf/competition/price-discrimination.htm*

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## 1. Definition of Price Discrimination

1. For purposes of this discussion, the U.S. Department of Justice and Federal Trade Commission (collectively, the "U.S. Agencies") define price discrimination as the roughly contemporaneous sale of different units of the same good or service at prices which vary by more than the difference in marginal cost of supplying those units. Variations in price are not price discrimination to the extent justified by cost differences.

2. For price discrimination to be feasible, two conditions typically must be met. First, suppliers engaging in price discrimination must be able to price differently to targeted (disfavoured) customers than to other customers. This may involve identifying individual customers to whom different prices are offered or offering different prices to different types of customers based on observable characteristics, including customer location and transaction size. In other cases, suppliers may be unable to distinguish among different types of customers but can offer multiple products that sort customers based on their purchase decisions.

3. Second, favoured customers must not be able to defeat the differential pricing by arbitrage; that is, by reselling the goods or services at issue, directly or indirectly, to targeted customers. Arbitrage may be difficult if it would void warranties or make service more difficult or costly for customers. Arbitrage is inherently impossible for many services. Arbitrage between customers at different geographic locations may be impractical due to transportation costs that are significantly higher in some locations than in others. Arbitrage on a modest scale may be possible but sufficiently costly or limited that it would not deter or defeat a discriminatory pricing strategy. For example, international grey markets generally do not eliminate significant price differences across countries.

4. New data gathering techniques potentially make it easier to price discriminate.[1] Consumer use of electronic devices, such as iPhones and computers, generates large amounts of data, including browsing history, user location, online purchases, and output on social media. These data can in turn be associated with an IP address or username. Given sufficient data, firms theoretically could model and predict differences in consumers' willingness to pay for a product or service, thereby making price discrimination more feasible.

5. However, there may be limitations on the ability to effectively price discriminate using such data. Data imperfections may limit the utility of data; in particular, consumers might operate anonymously by refusing to log-in, deleting internet cookies, or utilizing IP masks. Data can also be captured or utilized imperfectly, as companies have differing abilities to process the enormous volume of data available and translate it into functional models of consumer demand. As a result, the practical effect of new technologies on pricing strategies remains uncertain.

## 2. The Competitive Effects of Price Discrimination Are Difficult to Generalize

6. The competitive implications of price discrimination cannot be generalized easily. The consequences of firms having the ability to price discriminate rather than set uniform prices depend on market characteristics, including the nature and extent of competition. For example, discrimination in oligopoly markets tends to open up broader fronts of competition. In particular, firm asymmetries based on

1 President's Council of Economic Advisors, The Economics of Big Data and Differential Pricing (Feb. 6, 2015) https://www.whitehouse.gov/sites/default/files/whitehouse_files/docs/Big_Data_Report_Nonembargo_v2.pdf.

location differences, cost differences, or different product or service characteristics might cause firms to differ on which customers they would like to offer a low price (the firm's "weak" segment of the market) and which customers they would like to offer a high price (the "strong" segment of the market). For instance, it could be that one firm's weak segment is a competitor's strong segment. This might provide an incentive for a firm to offer discriminatorily low prices to its competitors' customers to obtain new business. Competitors might respond by meeting the competition. Accordingly, price discrimination is not intrinsically anticompetitive; rather, price discrimination can in some cases increase competition. Conversely, "denying a firm the right to meet the price of a competitor on a discriminatory price provides the [competitor] with some protection against price attacks . . . [and] weaken[s] competition."[2]

7. Price discrimination has been associated with three potential theories of competitive harm: (1) "exploitative" abuse; (2) primary-line, "exclusionary" effects; and (3) secondary-line, "distortionary," effects. Each theory is considered in turn.

### *2. 1 The United States Does Not Recognize "Exploitative Abuse" as an Antitrust Offense*

8. An exploitative abuse involves a firm with market power "exploiting" that market power, for example, by imposing an "excessive price." But U.S. antitrust law generally allows lawful monopolists, and *a fortiori* other market participants, to set their prices as high as they choose.[3] This central tenet of U.S. antitrust law is supported by court decisions that have held, for example, that "the mere possession of monopoly power, and the concomitant charging of monopoly prices, is not only not unlawful; it is an important element of the free-market system."[4] Moreover, a "natural monopolist that acquired and maintained its monopoly without excluding competitors by improper means is not guilty of 'monopolizing' in violation of the Sherman Act . . . and can therefore charge any price that it wants, . . . for the antitrust laws are not a price-control statute or a public utility or common-carrier rate-regulation statute."[5]

9. U.S. antitrust law, in almost all instances, does not prohibit firms from setting a "high" price because the freedom of a firm to determine the conditions (including price) upon which it sells its product or service is a central component of the free market. In a free market economy, price serves critical allocative functions. Price adjusts to balance supply and demand, and high prices often serve to attract investment to markets where it would create the greatest consumer benefit.

10. It could be argued that competition policy should prohibit price discrimination even if it permits simple monopoly pricing because price discrimination reduces static consumer welfare sufficiently more than simple monopoly pricing. However, such a claim has no basis in economics. Economic models show that "price discrimination may increase or decrease consumer welfare depending on market conditions."[6] As previously mentioned, in circumstances of oligopoly, price discrimination might increase competition when firms have asymmetric views of the customers to whom they would like to offer lower prices.

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2 Jacques-Francois Thisse and Xavier Vives, On the Strategic Choice of Spatial Price Policy, 78 Am. Econ. Rev. 122, 134 (1988).

3 A more complete discussion of the U.S. Agencies' views on excessive prices can be found at: Note by the United States, "Roundtable Discussion on Excessive Pricing," DAF/COMP/WP2/WD(2011)65.

4 *Verizon Communications, Inc. v. Law Offices of Curtis V.* Trinko, 540 U.S. 398, 407 (2004).

5 *Blue Cross and Blue Shield United of Wisconsin v. Marshfield Clinic*, 65 F.3d 1406, 1413 (7th Cir. 1995).

6 Dennis Carlton and Mark Israel, Should Competition Policy Prohibit Price Discrimination?, The Handbook of Competition Economics, at 13 (June 2009), available: http://compass-lexecon.s3.amazonaws.com/prod/cms-documents/74f9e7290f81f48c/Price_Discrimination.pdf.

11. Moreover, under certain circumstances, price discrimination might be necessary for the existence of the market.[7] Suppose that a market is characterized by high fixed costs, that the market has different groups of customers with different demands, and that no uniform price will yield revenues sufficient to cover the fixed costs. In such a circumstance, price discrimination might be the sole manner in which the product or service could be made available without government subsidy.

12. Finally, prohibiting "exploitative" price discrimination might undermine dynamic market competition. Denying a lawful monopolist the fruits of its monopoly can diminish its incentive to compete in the first place. As Judge Learned Hand aptly stated: "[t]he successful competitor, having been urged to compete, must not be turned upon when he wins."[8] The Supreme Court further elaborated on this notion in its 2004 *Trinko* decision, explaining that: "The opportunity to charge monopoly prices at least for a short period is what attracts business acumen in the first place; it induces risk taking that produces innovation and economic growth."[9] Therefore, limiting the freedom to set prices may well conflict with the underlying premise of antitrust policy, i.e. promoting a robust competitive process that produces high-quality, innovative goods.

### *2.2 Exclusionary Price Discrimination*

13. Price discrimination can be a feature of an exclusionary strategy meant to build or protect market power. In the United States, such "primary line" price discrimination theories of harm – that is, injury to competition between the discriminating seller and other sellers – can be investigated and challenged under the Sherman Act and the Clayton Act. In particular, Section 2(a) of the Clayton Act, as amended by the Robinson-Patman Act, prohibits sellers from engaging in price discrimination with respect to the sale of commodities "where the effect of such discrimination may be substantially to lessen competition or tend to create a monopoly in any line of commerce."[10] In *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, the Supreme Court held that "[b]y its terms, the Robinson-Patman Act condemns price discrimination only to the extent that it threatens to injure competition. The availability of statutory defenses . . . confirms that Congress did not intend to outlaw price differences that result from or further the forces of competition."[11] Thus, "primary line competitive injury under the Robinson-Patman Act is of the same general character as the injury inflicted by predatory pricing schemes actionable under Section 2 of the Sherman Act."[12] Hence, Sherman Act precedent informs the legality of primary-line price discrimination under the Robinson-Patman Act.

#### *2.2.1 Predatory Pricing*[13]

14. There is broad consensus that predatory pricing – that is, temporarily selling products or services at prices below a firm's costs – can, in certain circumstances, harm competition and consumers. Under U.S. law, to prove a predatory pricing claim, the plaintiff must be able to show that the defendant firm has

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7 William Baumol and Daniel Swanson, The New Economy and Ubiquitous Competitive Price Discrimination, 70 Antitrust Law Journal 661, 671-73 (2003).

8 *United States v. Aluminum Co. of America*, 148 F.2d 416, 430 (1945).

9 *Trinko*, 540 U.S. at 407 (2004).

10 15 U.S.C. § 13(a). Section 2 of the Clayton Act, as amended by the Robinson-Patman Act, is hereinafter referred to as the Robinson-Patman Act.

11 509 U.S. 209, 220 (1993).

12 509 U.S. 209, 221-22 (1993).

13 A more complete discussion of the U.S. Agencies' views on predatory conduct can be found at: Note by the United States, "Roundtable Discussion on Predatory Foreclosure," DAFFE/COMP/WD(2004)52.

priced below an appropriate measure of incremental cost. In addition, a predatory pricing claim must pass a recoupment test.[14] Predatory pricing does not always involve price discrimination, but selling products or services at predatorily low prices to some customers but not others can be used to reduce the financial sacrifice incurred by the predator, which may make recoupment more feasible.

### *2.2.2 Loyalty Rebates*[15]

15. There are several distinct pricing practices in business-to-business transactions in which a supplier's effective price to a particular customer is explicitly or effectively conditioned on the customer's cumulative purchases. A loyalty discount can induce a customer to purchase more by reducing the price that the customer pays for marginal units below the average price that the customer pays on all units. Simply reducing a single price charged on all units also can induce the customer to purchase more; however, a supplier likely can generate more revenue for a given quantity sold by using a pricing schedule with multiple prices and by reducing only the price for marginal units. With loyalty discounts, the same customer is effectively charged different prices on different units purchased, with the highest price charged on the first units. Hence, the practice can be considered a form of price discrimination.

16. In both form and competitive impact, a loyalty discount practice can resemble exclusive dealing, at least when the discount has a high market share target. Just like exclusive dealing, loyalty practices can promote cooperation between customers and suppliers by better aligning their incentives. However, U.S. courts recognize that "[e]xclusive dealing can have adverse economic consequences by allowing one supplier of goods or services unreasonably to deprive other suppliers of a market for their goods."[16] Experience with loyalty discount practices in the United States has indicated that they can, in some instances, have anticompetitive effects and that the antitrust laws, by focusing on harm to competition, can deal with them. Experience has also indicated that antitrust analysis of any loyalty discount practice requires a thorough understanding of the particular facts. In determining whether to challenge a loyalty discount practice, the Agencies perform a detailed evaluation of the practice's actual or likely competitive effects.

### *2.2.3 Margin Squeeze*[17]

17. Margin squeeze occurs when a vertically integrated firm forecloses a rival by setting a high price for an essential input squeezing the margin of a downstream rival. Margin squeeze may or may not involve price discrimination. In *linkLine* the Supreme Court ruled that U.S. antitrust law does not recognize margin squeeze as a distinct category of exclusionary conduct, although it can violate a duty to deal or entail predatory pricing in the downstream market.[18]

## *2. 3 Price Discrimination That May Cause Secondary-Line "Injury"*

18. Secondary-line price discrimination occurs when an upstream seller treats its downstream distributors/retailers differently in a manner not justified by cost differences. For example, a small retailer might be denied a discount made available to a large retailer.

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14 *See Brooke Group*, 509 U.S. at 222, 224.

15 A more complete discussion of the U.S. Agencies views on fidelity rebates can be found at: Note by the United States, "Roundtable on Fidelity Rebates," DAF/COMP/WD(2016)20.

16 *Jefferson Parish Hospital Dist. No. 2 v. Hyde*, 466 U.S. 2, 45 (O'Connor, J., concurring).

17 A more complete discussion of the U.S. Agencies' views on margin squeeze can be found at: Note by the United States, "Margin Squeeze," DAF/COMP/WP2/WD(2009)31.

18 *Pacific Bell Tel. Co. v. linkLine,* 555 U.S. 438 (2009).

19. In 1936, Congress amended the Clayton Act by enacting the Robinson-Patman Act, which was designed to prevent larger purchasers, such as chain store retailers, from securing lower prices from suppliers than smaller competing purchasers.[19] By its terms, the Robinson-Patman Act prohibits both buyers and sellers from agreeing on discriminatory prices. In practice, with respect to allegations of secondary line injury – that is, injury to competition between the favoured buyer and disfavoured buyers – case law permitted an inference of injury to competition to be drawn from the existence of a price differential sufficiently large to affect resale prices.[20]

20. Though the Robinson-Patman Act once was a mainstay of U.S. enforcement, a shift in emphasis based on economic analysis resulted in a significant reduction in enforcement actions brought by the Agencies under the Robinson-Patman Act. As a result, current enforcement of the Act occurs mainly through private treble damages actions. In a recent private action, the FTC submitted an *amicus curiae* brief on appeal to the Seventh Circuit Court of Appeals, clarifying its views of Section 2(e) of the Robinson-Patman Act, 15 U.S.C. § 13(e) – which "prohibits indirect price discrimination masked as promotional services or facilities." In the brief, the FTC urged the court to interpret the Robinson-Patman Act consistently with modern antitrust jurisprudence in the United States.[21] The only other recent agency action in relation to the Robinson-Patman Act came in 2014, when the FTC updated its *Fred Meyer* Guides to reflect legal developments and changes in technology and methods of marketing since the Guides were last revised in 1990.[22]

21. A 1977 DOJ Report on the Robinson-Patman Act found that prohibitions against secondary-line price discrimination affected competition in at least two ways. First, upstream price competition was chilled. Sellers and large buyers feared that bargaining over price would result in broad liability for discounting, and both groups of market participants refrained from doing so.[23] Second, the Act produced downstream inefficiency because low prices could not be used to steer costumers to more efficient distribution channels.[24] In 2007, the Antitrust Modernization Committee (AMC) recommended repealing the Robinson-Patman Act in its entirety on the basis that it is fundamentally inconsistent with the antitrust laws and harms consumer welfare.[25]

## 3. Conclusion

22. Price discrimination is common in many markets. In many instances, price discrimination enhances market competition. In the United States, price discrimination is often viewed as efficient. In certain limited circumstances, price discrimination might feature as an aspect of an exclusionary strategy meant to enhance or protect market power. Intervention should be limited to preventing these exclusionary abuses.

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19 15 U.S.C. §§ 13-13a.

20 *FTC v. Morton Salt*, 334 U.S. 37, 49 (1948).

21 *See* Brief for Federal Trade Commission, *Woodman's Food Mkt., Inc. v. The Clorox Co.*, 833 F.3d 743 (7th Cir. 2016), *available at* https://www.ftc.gov/system/files/documents/amicus_briefs/woodmans-food-market-inc.plaintiff-appellee-v.clorox-co.clorox-sales-co.defendants-appellants/151102woodmanvscloroxamicusbrief.pdf. In its brief, the FTC repudiated two previous Commission administrative decisions addressing Section 2(e) of the Robinson-Patman Act -- issued in 1940 and 1956 -- on the basis that "they are inconsistent with antitrust jurisprudence as it has developed in the last 60 years." *Id*. at 15.

22 *See Guides for Advertising Allowances and Other Merchandising Payments and Services*, 79 Fed. Reg. 58,245 (Sept. 29, 2014).

23 U.S. Department of Justice, Department of Justice Report on the Robinson-Patman Act 35-37 (1977).

24 *Id*. at 71-91.

25 Antitrust Modernization Committee, Report and Recommendations 317-18 (April 2007).