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An antitrust analysis of bundled loyalty discounts ☆

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Abstract

Consider a monopolist in one market that faces competition in a second market. Bundled loyalty discounts, in which customers receive a price break on the monopoly good in exchange for making all purchases from the monopolist, have ambiguous welfare effects. Such discounts should not always be treated as a form of predatory pricing. In some settings, they act as tie-in sales. Existing tests for whether such discounts violate competition laws do not track changes in consumer surplus or total surplus. We apply a new test to an illustrative example based on *SmithKline* that assumes the "tied" market has homogeneous goods. If the tied market is characterized by Hotelling competition, bundling by the monopolist causes the rival firm to reduce its price. In numerical examples, we find that this can deter entry or induce exit.

JEL classification: L42

Keywords: Market share discount; Bundling; Tying; Predation; *Ortho* test

1. Introduction

Bundled loyalty discounts provide price breaks on one or more products to buyers that remain sufficiently loyal to a supplier. They resemble volume discounts in that shifting incremental purchases from a rival supplier may allow a buyer to satisfy a loyalty requirement and thereby enjoy lower prices. They resemble tying when affordable prices for one (tying) product are available only to consumers that are completely loyal to the supplier in their purchases of a second (tied) product. Like volume discounts and tying, bundled loyalty discounts can enhance or diminish consumer surplus and total welfare by improving the ability to price discriminate, and they can change the long run incentives for single-product firms to enter/exit. Open questions include: under what conditions should competition authorities treat bundled loyalty discounts like tying or predatory pricing, and when do bundled rebates enhance welfare?

Bundled loyalty discounts have recently received considerable attention in antitrust circles in light of *LePage's,*

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Inc. et al. v. 3M Company,[1] *Michelin v. Commission*,[2] and a number of pending court cases.[3] Until recently, the practice of bundled rebates has received comparatively little scholarly and judicial scrutiny. Indeed, only a small number of cases litigated in the U.S. have focused squarely on these practices, including *SmithKline Corp. v. Eli Lilly & Co.*[4], *Ortho Diagnostics Sys., Inc. v. Abbott Lab, Inc.*[5], and *Cascade Health Solutions v. PeaceHealth.*[6] *Virgin Atlantic Airways Ltd. v. British Airways PLC*[7] involved similar practices, but the district court found allegations of anticompetitive behavior to be unsupported by fact. *LePage's* provides a good background for the issues involved.

The facts in *LePage's* begin with the very strong brand name of Scotch tape, a 3M product. Most retail merchants believed that they had to offer Scotch tape. Until the early 1990's, 3M's share of the U.S. market for transparent and invisible tape exceeded 90%. Starting in the early 1990's, however, 3M's share began to erode with the rise of office superstores such as Staples and Office Depot. These retailers sold products, including tape, under their own names as private labels. LePage's dominated the growing private label segment, with an 88% market share in 1992. Its share of the overall tape market, however, was only 14%.

3M responded by adding a private label of its own, under the Highland name. 3M's entry involved the use of a bundled rebate program that "offered discounts to certain customers conditioned on purchases spanning" multiple product lines, with the size of the rebate depending on the extent to which the customer met growth targets established by 3M. 3M's bundled discounts apparently proved successful in shifting a large fraction of private label tape business to 3M. In 1992, LePage's filed a four-count antitrust suit against 3M that was ultimately narrowed to a monopolization claim under Section 2 of the Sherman Act.[8] LePage's argued that it was foreclosed from selling private label tape because it could not cover its costs and still compensate customers for the rebates lost on *other* products in the discount program when the customer bought private label tape from LePage's instead of from 3M.

The legal strategy of the defendant, 3M, was to argue that as long as the price of the bundle exceeded its cost, the pricing scheme was legal. In other words, 3M argued that the relevant case law was that of predatory pricing, as presented in *Brooke Group*.[9] In its appellate filings following an initial jury verdict in favor of LePage's, 3M used a different approach, the *Ortho* test. In *Ortho*, the defendant offered bundled discounts on products,[10] some of which were competitive and some of which were monopoly products due to patents. The District Court in *Ortho* allocated the total bundle rebate to the competitive product in question and compared that globally discounted price to the defendant's cost. This approach takes the idea behind the *Brooke Group* test, and for bundled rebates, applies it incrementally to the competitive product. According to this test, if the discount-adjusted price of the competitive product exceeds its cost, then the bundled discount pricing strategy is deemed not anticompetitive.

In *LePage's*, a circuit court panel reversed the original verdict and found that the plaintiff had to show that 3M prices were below some measure of cost (where costs might include rebates provided on other products). LePage's provided no such price-cost proof, yet when the case was reheard *en banc*, the Third Circuit restored the original jury verdict and rejected the necessity of showing that 3M had failed a price test. To quote the U.S. Department of Justice:

> …The court of appeals was unclear as to what aspect of bundled rebates constituted exclusionary conduct, and neither it nor other courts have definitively resolved what legal principles and economic analyses should control.[11]

The great interest in *LePage's* probably stems from the fact that bundled rebates are a widespread business

[1] 324 F.3d 141 (3rd Cir. 2003).

[2] Case T-203/01 Manufacture francaise des pneumatiques Michelin v Commission [2003] ECR II-4071.

[3] See, for example, reports on litigation involving pharmaceuticals (Hensley, 2004; Pollack, 2005) and microprocessors (Parloff, 2006), as well as Antitrust Modernization Commission (2005, 2007), European Commission (2005), and the commentary of Ahlborn and Bailey (2006).

[4] 427 F. Supp 1089, 1094 (E.D.PA.1976); 1976 U.S. Dist. LEXIS 12486j 1976-2 Trade Cas. (CCH), P61, 199.

[5] 920 F. Supp. 455 (1996).

[6] 05-35627 D.C. No. CV-02-06032-ALH (9th Cir. 2007).

[7] 257 F. 3d 256 (2001). A similar lawsuit was litigated in Europe: Case IV/D-2/34.780.

[8] One of the four counts was exclusive dealing. The jury found against LePage's on this claim.

[9] *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.* 509 U.S. 209 (1993).

[10] In the context of these cases, bundling refers to a set of discount prices that are only available if the relevant products are bought largely or entirely from the dominant multi-product firm. This differs from the standard usage in economics, where bundling refers to the sale of a set number of units of various goods.

[11] *Brief for the United States as Amicus Curiae*, 3M Company FKA Minnesota Mining and Manufacturing Company, Petitioners, and LePage's Incorporated, et al. On Petition for a Writ of Certiorari to the United States Court of Appeals for the Third Circuit, at 8.