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CENTRE FOR COMPETITION POLICY

Exclusionary Discounts

June 2007
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CCP Policy Briefing

BACKGROUND

- Manufacturers often encourage retailers to promote their products by offering discounts if the retailers' purchases meet or exceed certain quantity or share thresholds.
- Generally such discounts are a sign of healthy price competition, and are often required by buyers as a price of doing business; however, in other circumstances these discounts may be anticompetitive and may instead create incentives for a retailer to promote the sale of products on which it is eligible to earn a discount primarily at the expense of other, substitute products, which may have been preferred by consumers.
- This paper will show that, when implemented by a dominant firm, these discounts can sometimes exclude equally efficient rivals, misallocate resources, and lower overall welfare.

METHODOLOGY

- This paper considers a simple two-period model with two manufacturers and one retailer – where two sellers compete to sell their goods to a single buyer – in which there is complete information and the efficient outcome calls for the retailer to buy one unit from each manufacturer in each period.
- It focuses particularly on the role of negative prices in supporting equilibrium outcomes – when are they necessary, when are they superfluous, and when can they not support equilibria.
- That allegedly harmful discounts can arise in both efficient and exclusionary equilibria is an attractive feature of the model. However, it begs the question whether it is possible *ex ante* to distinguish procompetitive discounts from anticompetitive discounts. If the dividing line is drawn too aggressively, one risks chilling price competition that would ultimately benefit consumers in the form of lower retail prices, but if the line is drawn too passively, the dominant manufacturer may be able to exclude its rival, which leads to fewer product choices and reduces overall welfare.
- These tradeoffs are examined by considering first the consequences in the model of a ban on offer in which a seller charges a price that is below its marginal cost of production, and then the welfare effects of a ban on negative prices.

KEY FINDINGS

- When the retailer's – or his customers' – valuations between periods are linked by switching costs and at least one seller is financially constrained, there are plausible conditions under which exclusion (the retailer buys from only one manufacturer) arises.
- Negative prices can arise (under some conditions) in both efficient and exclusionary equilibria.
- A common feature of exclusionary equilibria is that they are supported by price-quantity offers in which the excluding firm offers to sell its incremental unit for a price that is below its marginal cost of production.

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- A ban on offers in which a seller charges a price that is below marginal cost of production always yields a first-best outcome in the model (the buyer will always purchase one unit from each seller).
- A ban on negative prices does not always eliminate the possibility of exclusion, but does, however, reduce the set of circumstances under which such equilibria arise, and in that sense it is welfare improving.

POLICY ISSUES

- Two potential remedies that a policy maker might adopt to ease competitive concerns:
    - A ban on below-cost pricing was shown to be sufficient to eliminate all exclusionary equilibria and, in that sense, was a first-best welfare improvement. However, such a prohibition might be difficult to enforce.
    - A ban on negative incremental prices (i.e. no decreases in the buyer's total outlay schedule) was also welfare improving, although in a perfect world it would be a second-best solution in the sense that it would not suffice to eliminate all exclusionary equilibria. Nevertheless, this might be preferable in the real world because of its ease of implementation.

THE CCP

The ESRC Centre for Competition Policy (CCP), at the University of East Anglia, undertakes competition policy research, incorporating economic, legal, management and political science perspectives, that has real-world policy relevance without compromising academic rigour.

FOR MORE INFORMATION

The full working paper (CCP Working Paper 07-13) and more information about CCP and its research is available from our website: www.ccp.uea.ac.uk

ABOUT THE AUTHORS

- **Professor Greg Shaffer** teaches in the Simon School of Business at the University of Rochester. He visited CCP for 6 weeks from May-June 2007 to work with various members on buyer power and welfare effects in vertical markets and mergers. His research employs game-theory models to examine issues in pricing policies, antitrust and regulation, distribution channels, vertical restraints, principal-agent theory, and oligopoly models of strategic competition.
- **Professor Janusz Ordover** is based in the Department of Economics at the University of New York. His research interests are industrial organisation, antitrust economics and policy, and applied microeconomics.

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