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Most Favoured Customer Clauses: Abuse of Dominance or Abuse of Discretion?

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Most favoured customer clauses have risen to increasing prominence in both leading antitrust systems over the past two years. In the European Union, this came in the form of a little noted, but potentially significant, settlement with the Hollywood majors regulating their investment in new cinema equipment. In the United States, litigation relating to most favoured customer clauses used by a major health insurer, Blue Cross Blue Shield of Michigan, continues to grab headlines in the professional press. The approach adopted in these cases may significantly impact the wide variety of contracts currently employing most favoured customer clauses. This piece will argue that the concerns raised in recent cases largely fall away with due regard to market power and consumer welfare criteria.

Stated very simply, a most favoured customer clause, or MFC, requires a supplier to offer its lowest price to the beneficiary of the clause. Therefore if A benefits from an MFC, he will be able to claim damages if the supplier sells to B for less. In some circumstances, this leads to an antitrust concern that the supplier will refuse to discount to B for fear of having to lower the price to A, possibly increasing price rigidity and creating a barrier to entry. Additionally, it is alleged that an MFC can assist potentially problematic exchanges of information, and might lower the monitoring costs involved in a cartel by highlighting discounting.

In the majority of cases, these anticompetitive effects are unlikely. In fact, the opposite is true: an MFC clause is frequently a potent source of price competition. Its clearest effect is to limit the scope for price discrimination against its beneficiary, although it should be noted that the welfare effects of price discrimination are famously complicated. An MFC can also ensure that all purchasers benefit from year-on-year efficiency increases common in some industries, such as parts manufacture, which is particularly useful where there is an information asymmetry between buyer and seller.

Beyond these intrabrand effects, and perhaps related to them, there is also empirical support that an MFC can support interbrand competition. For example, recent research by Chen and Liu in the *Journal of Industrial Economics* found that the introduction of an MFC by a "big box" retailer in the United States sparked a potent price war: not only did Best Buy lower its prices by 1.6% having adopted an MFC, but its competitors responded with price reductions of up to 3.5%. The result strongly suggests that the treatment of MFCs under antitrust law should generally be favourable: despite posing no more than a threat to intrabrand competition in themselves, they appear to be useful tools in competitive strategies resulting in greater interbrand competition.

Indeed, the strong competitive justifications for MFC clauses led none less than Chief Judge Posner to refer to antitrust arguments against them as "ingenious but perverse." [1]

For its part, the European Commission appeared to appreciate the benefits of an MFC when it accepted one as part of the *Rambus* settlement. Eighteen months later, however, the Commission was far more concerned by the potential competitive harms from MFCs when called upon to investigate the contracts used by the Hollywood majors to invest in the latest digital equipment currently being installed in cinemas. In the United States, these have followed a "virtual print fee" model under which a third party "integrator" pays for digital equipment, often on credit, and installs it in the cinema. The studio then pays a fee to the integrator each time a film is shown.

The virtual print fee model incorporates a most favoured customer clause. Under the circumstances, this is easily explained: several studios are investing in the equipment, and wish to make sure that competing studios cannot gain access to their investment more cheaply. Indeed, the MFC allows the studios to share the substantial costs involved in updating cinemas without any single studio becoming a free rider on the investment. Their choice to invest in this way suggests that it is more efficient than other solutions, such as vertical integration, which presumably would involve higher transaction costs and present less scope for sharing investment in equipment, which tends to be only intermittently used by any one studio. The virtual print fee model, complete with MFC, therefore appears to be a potent means to facilitate investment in the latest cinema equipment, accelerating its adoption to the benefit of consumers.

Nonetheless, the European Commission was concerned about the possibility that the MFC might prevent small budget and art house films from gaining access to the latest equipment. Although the case was ultimately settled, and the reasoning is therefore not public, the concern appears to have been that the MFC would prevent the smaller studios from gaining access to the equipment, as the lower price offered to them would also need to be offered to the Hollywood majors. On this view, the MFC amounted to a price floor, at least as far as the smaller studios were concerned. The Hollywood majors decided to settle by agreeing to alter the contractual terms to the satisfaction of the Commission.

The Commission press release following the settlement raised as many questions as it answered. [2] First, it is difficult to articulate a credible theory of consumer harm on the basis of the details it disclosed. As the Commission noted, only half of cinemas are forecast to have the digital equipment by the end of 2012. There is therefore ample scope for smaller studios to make use of older and cheaper equipment. One can also query the market power of the Hollywood majors: besides the competitive constraint of existing equipment, they also compete very strongly with each other. In the absence of market power on the part of the studios, it seems relatively safe to assume that independent cinemas could adopt a different investment model to meet consumer demand should consumers be harmed by the actions of the Hollywood majors.

In fact, it seems much more likely that the virtual print fee model simply reflects the overwhelming share of consumer demand wishing to see the latest Hollywood blockbusters on state-of-the-art equipment, and the pressure applied by the Commission could therefore be interpreted as an attempt to redistribute sunk investment away from consumers to a politically favoured group. To the extent that this approach to antitrust law is considered irregular, it is remarkable that the Commission went so far as to draw attention to its political agenda in the concluding paragraph of its press release. Although the details will necessarily remain obscure, there is a strong possibility that the settlement has slowed the adoption of the latest equipment at the expense of the welfare of the average consumer.

The competitive effects of MFCs have been discussed more fully in the ongoing *Blue Cross Blue Shield* litigation in Michigan.[3] Here, the U.S. Department of Justice alleges that an MFC used in contracts between insurers and hospitals harms competition by setting a price floor in the market. The primary allegations concern a 16% premium paid by Blue Cross in exchange for MFC and “MFC plus” clauses, the latter requiring an additional discount beyond that granted to other insurers.

Despite its 60% market share in some markets, it is not immediately clear that consumer harm would necessarily result from the Blue Cross clauses. It might be credible, even likely, that some hospitals would not discount to other insurers for fear of having to cut prices to Blue Cross, presenting the same issue the Commission was concerned about in *Hollywood Integrators*. However, so long as other hospitals continue to transact with other insurers, there is little scope for Blue Cross to increase prices in the longer term. If Blue Cross is to pay a premium to the hospitals granting an MFC, as is alleged, it would need to pass this cost on to consumers through increased insurance premia. This would create significant scope for a competing insurer to undercut Blue Cross by contracting with a competitive hospital, and the larger the rents allegedly generated by Blue Cross the stronger the incentives for this competition to occur.

It may be the case that a hospital in a particular region has a degree of market power over its locality, but it seems fanciful to suggest that a hospital would wish to share this market power with an insurance company by means of an MFC, even were it able to monopolise such a heavily regulated market. In the absence of a credible articulation of lasting market power in a relevant horizontal market, the far more likely explanation of the MFC is that Blue Cross values it as a cost-cutting device designed to exclude opportunistic price discrimination by hospitals. For this reason, it may be worth spending money on, but it does not indicate an attempt to monopolise.

The *Blue Cross* litigation makes it clear that the argument against MFCs is at heart a predatory pricing theory. Essentially, the allegation is that Blue Cross is generating a monopoly rent by paying hospitals extra to ensure that competitors do not get access to the lowest prices. On this view, the MFC is therefore functionally equivalent to the low price offered by a monopolist in a predatory pricing case: the alleged monopolist is “investing” in undercutting competitors, supposedly to foreclose their access to the market. As counsel for Blue Cross pointed out, this theory should be treated with the same scepticism as would a predatory pricing theory, at least in the United States. Although the Department of Justice did not cite them in its complaint, the Supreme Court precedents in *Matsushita* and *Brown & Williamson* draw on a wealth of economic thinking to suggest several problems with many aspects of predation arguments. If the theory is to hold, not only would Blue Cross need deep pockets to finance the increased outlay on its large share of sales, but it would also need to ensure that new competitors could not re-enter the market were it to succeed in driving up prices and charging a monopoly rent, presenting numerous hurdles to the would-be monopolist, to say nothing of potential consumer benefit from any ensuing price war.

In *Blue Cross*, the Department of Justice survived summary judgment partly on the basis that a detailed market-by-market analysis is not required at the pleading stage. The market-by-market analysis at full trial therefore provides an opportunity to explore the underlying theory of harm relating to MFCs in greater depth. Given the shifting fortunes of MFCs in recent antitrust analysis, this is a welcome opportunity.

An overly-suspicious approach to MFCs could easily foreclose their potential to cut prices, which seems desirable even in the hands of larger players. Moreover, the status of MFCs as vertical, intrabrand restrictions suggests an additional note of caution, as does their relationship to predation theory. Kenneth Heyer, Chief of the Competition Policy Section at the Department of Justice, recently suggested using the analytic framework of the *Horizontal Merger Guidelines* by analogy to assess the competitive effects of MFCs. A clear focus on market power and consumer harm, as influentially articulated by the *Guidelines*, would seem a sensible approach to the assessment of MFCs on both sides of the Atlantic.

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