

**Douglas Melamed**

WilmerHale – Washington, DC, USA



***Thoughts about Exclusive Dealing***

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**A. Douglas Melamed<sup>1</sup>**  
**Thoughts about Exclusive Dealing**  
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Exclusive dealing, which in Europe is sometimes called “single branding”, refers to arrangements pursuant to which a firm (“the Firm”) induces an input supplier to deal with it but not with its competitors. In its simplest and perhaps most common form, a manufacturer enters into an agreement with a retailer pursuant to which the retailer purchases and resells the manufacturer’s products and agrees not to deal in competing products.<sup>2</sup> The term “exclusive dealing” can also be used to refer to less precise and formal arrangements, such as those which: provide for partial exclusivity (e.g., where at least 75% of the retailer’s sales must be of the Firm’s products); entail unilateral contracts that offer incentives for but do not require promises of exclusivity (e.g., where the Firm offers a large year-end rebate if the retailer sells \$X of the Firm’s products, or if 90% of its sales consist of the Firm’s products during the year); or induce exclusivity by non-contractual threats (e.g., where the Firm announces that it will not deal with retailers that do business with its competitors).

**Injury to Competition and the Easy Cases**

Exclusive dealing can injure competition if it excludes competitors of the Firm or raises their costs and thereby enables the Firm to gain or maintain market power that it would otherwise not have. Exclusive dealing can exclude or raise the cost of competitors by denying them access to needed inputs, forcing them to obtain more costly inputs, or causing their sales to diminish and thus driving them below efficient scale.

Proof that the exclusive dealing has injured or is likely to injure competition in this way should be a precondition to condemnation of the exclusive dealing under the antitrust or competition laws. Absent such effects, exclusive dealing is benign from an antitrust or competition law perspective; and because (as discussed below) exclusive dealing can be efficient and can benefit consumers, condemning it without proof of injury to competition will almost surely result in false positives that would reduce efficiency, competition and welfare.

On the other hand, exclusive dealing can be readily condemned under the antitrust laws if (i) it causes actual or likely injury to competition, and (ii) the exclusive dealing

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<sup>1</sup> Partner, Wilmer Cutler Pickering Hale and Dorr LLP. Einer Elhauge, Rick Warren-Boulton and Greg Werden each provided valuable comments on an earlier draft of this paper.

<sup>2</sup> In this example, the retailer is the input supplier, and the input is retail distribution services. While it might seem odd to refer to a downstream firm as an input supplier, the uniform use of the term “input supplier” simplifies exposition by enabling analysis of the issue without regard to whether the constrained entity is upstream or downstream from the Firm that induced the exclusivity.

provides no plausible efficiency benefit under the circumstances. If these conditions are proven, exclusive dealing can be regarded as a form of “naked exclusion” – conduct that excludes rivals, creates or maintains market power and cannot be justified.<sup>3</sup>

### **Benefits from Exclusive Dealing**

Exclusive dealing can have a variety of benefits for efficiency and competition. In fact, because exclusive dealing is commonly used in circumstances in which there appears to be no realistic prospect that it will create market power, it is presumably widely thought to provide efficiency benefits. Some might suggest that efficiency should be the default explanation for exclusive dealing.

Exclusive dealing can provide numerous types of benefits, not all of which can be catalogued here. Broadly speaking, the most common benefits appear to fall into two related categories. The first has to do with aligning the incentives of the Firm and the input supplier. For example, if a retailer sells the Firm’s products and not those of its competitors, it will have an incentive to maximize the sales of those products, and the Firm will thus have increased incentives to deal with the retailer. The second has to do with protecting and thus inducing efficient, relationship-specific investments. For example, a distributor (the Firm, in this example) might need assurance that the manufacturer will not dilute the distributor’s sales by dealing with multiple distributors before it will invest in a new and more efficient distribution facility. Or the Firm might need assurance that a retailer will not divert customers to competitors’ products before it will support a promotional campaign designed to attract more customers to the retailer.

Although exclusive dealing can provide benefits, it might not be necessary for those benefits. For example, under some circumstances, the Firm might be able to align retailer incentives for point of sale services by paying directly for those services, rather than by requiring the retailer not to deal with competitors. Or the Firm might reasonably need exclusive relationships with a number of distributors but might not need such relationships with every distributor. For purposes of this paper, exclusive dealing will be regarded as providing benefits only if there is no other way that comparable benefits could be provided without a material increase in cost and with materially less risk of injury to competition.

A Firm that is likely to obtain market power as a result of exclusive dealing is, all other things being equal, more likely to use exclusive dealing to achieve benefits that could be achieved in other and perhaps less restrictive ways. Thus, a careful inquiry as to whether exclusive dealing is really needed to obtain the benefits is probably most appropriate where

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<sup>3</sup> As a logical matter, one could reverse the presumption implicit in these two paragraphs and argue that the law should condemn all exclusive dealing that cannot be shown to have efficiency benefits under the circumstances, without regard to proof of injury to competition, in order to guard against the risk of false negatives. US law wisely rejects this approach (i) because efficiencies from exclusive dealing are so common that an injury-to-competition screen is needed to guard against false positives, and (ii) because of a more generalized belief that government should refrain from intervening in commercial arrangements absent proof of a good reason to intervene (a belief which in turn derives from the risk of errors of any such intervention and of capture of the government by factions, the direct costs of frequent government intervention, and indirect demoralization costs of frequent government intervention).

the incremental market power created or likely to be created by the exclusive dealing is greatest.

### **Balancing Harms and Benefits**

The difficult question for antitrust law is how to treat exclusive dealing that both injures competition and provides benefits. As explained above, if it does not injure competition or if it does injure competition but provides no benefits, the antitrust issue is simple. But what if exclusive dealing both causes harm and provides benefits?

(1) One approach would condemn exclusive dealing if the injury to competition were substantial, regardless of the benefits. There is language in DG Competition's Discussion Paper on Article 82<sup>4</sup> which appears to support a condemn-if-harmful approach.<sup>5</sup> Such an approach could be defended on normative grounds (i.e., taking the view that preserving rivalry is preferable regardless of its effects on economic welfare) or on the empirical ground that such a rule is most likely to enhance welfare.<sup>6</sup> The normative rationale is, at least from a US perspective, not an appropriate or desirable objective of the antitrust laws, which are intended to prevent conduct that impairs economic welfare.

The empirical rationale, which is in effect a categorical judgment that the harm outweighs the benefits in general, seems to be little more than a guess of, at best, dubious accuracy. To be sure, a short-term efficiency gain can be outweighed by long-term welfare losses from resulting market power in individual cases. But, especially in times of rapid technological change and economic transformation, market power will often prove to be transitory and will often be eroded by forces that cannot be anticipated. A law that prohibited efficient exclusive dealing whenever it seems likely to injure competition would thus deter a wide range of efficient conduct that might lead, at most, to only short-lived market power. Perversely, such a law would be especially likely to deter the most efficient conduct (because that conduct is most likely to disadvantage rivals and lead to market power) and would encourage rivals to seek refuge from efficient competition by seeking legal remedies rather than by competing in the marketplace. Because the empirical premise for the condemn-if-harmful approach seems unlikely to match reality, the approach is unsound.

Moreover, even if it were true that exclusive dealing which threatens competition is in general likely to cause harm that outweighs the benefits, a general rule condemning all such exclusive dealing would still be problematic. Such a rule would be desirable only if it could be shown to be superior to a rule that sought to distinguish those cases in which the harm exceeds the benefits from those in which the benefits exceed the harm and to condemn only the former.

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<sup>4</sup> *DG Competition discussion paper on the application of Article 82 of the Treaty to exclusionary abuses* (Dec. 2005), <http://ec.europa.eu/comm/competition/antitrust/art82/discpaper2005.pdf>.

<sup>5</sup> See *ibid.*, para. 54 ("The essential objective of Article 82 . . . is the protection of competition . . . [and] to ensure that these competitors are able to expand in or enter the market and compete . . ."); para. 84 (efficiency defense applicable only if "competition in respect of a substantial part of the products concerned is not eliminated"); para. 91 ("Ultimately the protection of rivalry and the competitive process is given priority over possible pro-competitive efficiency gains.")

<sup>6</sup> The latter is the rationale stated in the Discussion Paper. See *ibid.*, para. 91 ("When competition is eliminated . . . short-term efficiency gains are outweighed by longer-term losses . . .").

(2) An alternative approach would be to have different rules for different kinds of exclusive dealing, based on empirical judgments about the likely benefits and harms of the particular kind of agreement. For example, exclusive dealing agreements could be prohibited if more than a certain percentage of input suppliers are constrained, and they could be permitted if their duration were less than a certain length of time. While such more refined categories could in principle reduce the likelihood of empirical error, they are still not likely to correlate closely with the welfare implications of the arrangements.<sup>7</sup> Moreover, different rules for different categories would have other disadvantages as well. In particular, they would: lead to decisions based on formalisms; induce parties to make inefficient changes to their conduct in order to increase the likelihood that the conduct would be deemed to fall into a more lenient category; invite disputes about how to categorize conduct; and increase transaction costs, both *ex ante* (when business are trying to decide how to act) and *ex post* (when categorization disputes arise in litigation). At the very least, there needs to be a default rule to give guidance to businesses, agencies and courts about how to assess the lawfulness of a new form of exclusive arrangement that does not seem to fall into any of the more precise categories.

(3) Yet another approach would be literally to balance the harms and the benefits from the exclusive dealing at issue in the individual case. Several commentators in the US have advocated such an approach.<sup>8</sup> While such an approach almost tautologically makes sense as a theoretical matter, it makes little sense as a practical matter. Imagine that the Firm implements an exclusive dealing program which predictably will reduce its costs or increase its sales by a certain amount and which is likely to harm competitors of the Firm both by increasing sales of the Firm's product and by increasing the competitors' costs. In order to balance the harms against the benefits, an antitrust agency or court would have to quantify both.

Quantifying the benefits (to the Firm and its customers, including new customers generated by the exclusive dealing) with acceptable accuracy might be feasible if only a little accuracy were required for the determination to be acceptable. If consumer welfare were the measure, quantifying the benefits would require estimating consumer surplus in the world without the exclusive dealing and the extent to which that surplus would be increased by the exclusive dealing. Increased consumer surplus would reflect (i) any outward shift in the demand for the Firm's products because of enhanced quality of or point of sale services for those products, and (ii) any outward shift in the supply curve, attributable to the exclusive dealing, together with (iii) any changes in those factors over time.

Quantifying the harms would be more difficult. If total welfare were the measure, the agency or court would have to weigh impacts rippling throughout the economy – surely an impossible task. If consumer welfare were the measure, the agency or court would have to measure the welfare loss to consumers who would have done business with the Firm's competitors, but for the exclusive dealing, and who are harmed by the exit or increased costs

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<sup>7</sup> For example, a safe harbor for short-term agreements would fail to prohibit a monopolist that induced exclusive dealing without any agreement at all simply by threatening not to deal with input suppliers that were not exclusive. See, e.g., *Lorain Journal Co. v. United States*, 342 U.S. 143 (1951).

<sup>8</sup> See, e.g., Steven Salop, "Exclusionary Conduct, Effect on Consumers, and the Flawed Profit-Sacrifice Standard", 73 *Antitrust Law Journal* 311 (2006).

of those competitors. The calculation would have to take into account, among other things, the benefits to some of those customers who shift to purchasing the Firm's products, the possibility that perhaps unanticipated new entry or innovation spurred by the Firm's success will offset the harm to competition, and the likely duration of the harm (which presumably must be discounted to present value).

Balancing thus seems like an impossible task. In fact, although US courts often pay lip service to balancing the harms and benefits resulting from exclusionary conduct, they rarely if ever actually try to balance them.<sup>9</sup> Balancing is at best an invitation to make arbitrary decisions based on guesses, imperfect information, or bias.<sup>10</sup>

Even if balancing could be done by agencies or courts with acceptable objectivity and accuracy, a legal rule based on balancing would still be unwise. The impact of antitrust rules on the millions of decisions that businesses make every day and that never become the subject of investigation or litigation is far greater than, and far more important than, the impact of antitrust rules on cases that are the subject of government investigation or litigation. While it is important that antitrust cases be fairly and correctly decided, it is even more important for antitrust rules to give useful and sound guidance to the business community. Antitrust law ought therefore to strive for rules that minimize the sum of: (i) the costs businesses must incur to determine what the law requires; (ii) the costs of beneficial conduct that the rules deter; and (iii) the costs of the harmful conduct that the rules do not deter. Balancing tests plainly do not minimize such costs. If a business in real time has to inquire whether a contemplated efficiency-generating exclusive dealing arrangement will create more harm than benefit before implementing the arrangement, it will: (i) have to spend substantial resources to investigate that question; (ii) likely need to postpone implementing the arrangement; (iii) avoid the arrangement regardless of its efficiencies because of an unwillingness to bear the legal risk or an inaccurate estimate of costs and benefits; and/or (iv) ignore the law and hope that the arrangement does not become the subject of an investigation or lawsuit. None of these is a desirable outcome.

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<sup>9</sup> In the *Microsoft* case, for example, the court appeared to adopt a balancing test: "[I]f the monopolist's procompetitive justification stands un rebutted, then the plaintiff must demonstrate that the anticompetitive harm of the conduct outweighs the procompetitive benefit." *United States v. Microsoft Corp.*, 253 F.3d 34, 59 (D.C. Cir. 2001) (*per curiam*). But the court did not engage in any real analysis of that step, and it is not clear what the court meant by that language. The court found that almost all of the defendant's allegedly anticompetitive conduct had no justification at all and concluded that the conduct was illegal without any balancing. It simply asserted, without explanation, that the one or two aspects of the challenged conduct that it found had some pro-competitive effect were for that reason lawful. Thus, notwithstanding its use of the rhetoric of balancing, the court might in substance have meant simply that conduct will be found to be anticompetitive only if it has no pro-competitive benefits at all.

<sup>10</sup> Proponents of balancing sometimes assert that balancing is simply the familiar "rule of reason" test that has long been used to assess joint ventures and other horizontal restraints. In fact, however, the rule of reason test in such cases is more like the "no economic sense" test discussed below than the balancing test. The rule of reason in horizontal cases asks whether the arrangement is likely to increase or reduce the output of *the parties to the agreement*. By contrast, balancing in cases of exclusionary conduct requires a balancing of the impact of the arrangement on the parties to the arrangement against the impact on *third parties* – competitors and their customers. That is a far more daunting task.

## The Beauty of Looking Inward

Decisions in US monopolization cases frequently state that a defendant is entitled to the fruits of its success or its dominance if that dominance was obtained by “superior product [or] business acumen”<sup>11</sup> or by “skill, foresight and industry”.<sup>12</sup> The implication is the mirror image of the condemn-if-harmful rule discussed above. The implied rule would permit the use of exclusive dealing arrangements, regardless of their effect on competition, if under the circumstances they constitute a form of competition on the merits – which presumably refers to competition on the basis of efficiency.

A rule that focuses on the conduct of the Firm has two principal virtues. First, it is much easier to apply, especially by businesses in real time, than a balancing test. Instead of trying to analyze the benefits of the exclusive dealing arrangement, conditions in the market, the ability of rivals to respond, the likelihood of innovation and entry, and the likely time dimensions of all the above, the Firm – or an antitrust agency or court – needs to analyze only the efficiency of the exclusive dealing arrangement for the Firm itself.

Second, a rule that focuses on the conduct of the Firm reflects an important normative principle rooted in the liberal tradition in the US. It is that businesses should be free to conduct themselves as they see fit unless they engage in damnable conduct. And whether conduct is damnable depends on the nature of the conduct, not on its competitive consequences.

Competition on the merits refers to competition on the basis of efficiency. But it need not and should not be a flabby concept that permits any conduct that has any efficiency properties. Such a rule would permit the Firm to use arrangements which have some efficiency benefits but which, on balance, would not make sense for the Firm absent their tendency to exclude rivals from the market and create or maintain market power for the Firm. So, competition on the merits should mean *conduct that makes business sense for the Firm – because it is profitable for the Firm, taking into account opportunity costs – regardless whether it creates or maintains market power for the Firm*. This is sometimes called the “No Economic Sense” (“NES”) test.

As a general matter, the NES test ensures that equally efficient competitors will not be excluded and condemns only conduct that reduces welfare in a static sense. If applied sensibly, it presents little risk of false positives.

### The “No Economic Sense” Test Applied to Exclusive Dealing

The principle that competition on the merits is lawful means that exclusive dealing is permissible, regardless of whether it injures competition, if it would have been profitable for the Firm even if it had not injured competition, after taking into account available alternatives such as non-exclusive or less exclusive arrangements with the input suppliers or exclusive arrangements with fewer input suppliers. Its application thus requires a comparison of the

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<sup>11</sup> *United States v. Grinnell Corp.*, 384 U.S. 563, 570-71 (1966).

<sup>12</sup> *United States v. Aluminum Co. of America*, 148 F.2d 416, 430 (2d Cir. 1945).

benefits derived by the Firm from the exclusive dealing – increased sales, reduced costs, more predictable input supplies, or whatever – against the cost to the Firm of that arrangement.

The basic cost to the Firm of an exclusive dealing arrangement is a result of the following simple fact: exclusive dealing is costly to the input supplier because it has to forego dealing with the Firm's competitors. Those costs borne by the input supplier could lead to a downward shift in its demand for dealing with the Firm, or it could induce the input supplier to insist on explicit compensation for the exclusive dealing. Either way, those costs should be internalized to the Firm, which will presumably take them into account in determining whether to induce its input suppliers to deal exclusively with it. For example, if the Firm were to give a retailer a choice of dealing exclusively or non-exclusively, the retailer will presumably require a lower price for dealing exclusively.<sup>13</sup> That price differential is the cost to the Firm. The Firm presumably compares that cost with the benefits from exclusive dealing in deciding whether to choose an exclusive dealing arrangement. In applying the NES test, that comparison is undertaken without regard to any benefits to the Firm from the possibility that the exclusive dealing arrangement will create or maintain market power for the Firm. In other words, the NES test begins with the recognition that an exclusive dealing arrangement imposes an opportunity cost on input suppliers and asks whether that cost is fully defrayed by the efficiencies generated by the arrangement.<sup>14</sup>

In the case of exclusive dealing and other types of exclusionary vertical agreements, the costs incurred by the Firm should be a rough proxy for the sum of the costs incurred by the input suppliers and competitors of the Firm as a result of the exclusive dealing. If the exclusive dealing harms or threatens to harm the Firm's competitors, they will presumably be willing to pay to some or all of the input suppliers compensation up to the amount of the harm to induce them to reject the exclusive dealing. The opportunity cost to the input suppliers of exclusive dealing will reflect these potential defensive payments from the Firm's competitors and will thus reflect the harm to those competitors from the exclusive dealing. And that opportunity cost should be included in the costs of exclusive dealing that are ultimately borne by the Firm.

If the benefits, calculated without regard to the prospect of excluding rivals and gaining or preserving market power, exceed those costs, the exclusive dealing would be efficient and it would be permissible under the NES test. If the costs exceed those benefits, and if the exclusive dealing excludes or raises the costs of rivals and thus creates or is likely to create market power for the Firm, then the exclusive dealing will be unlawful. In that event, the exclusive dealing would be inefficient; it would not make sense for the Firm but for the likelihood that it will injure competition and create or maintain market power for the Firm.

Care must be taken not to confuse the legitimate benefits of an arrangement with its anticompetitive consequences. For example, suppose the Firm implements an exclusive dealing arrangement that entails large up-front capital costs (perhaps for a distribution

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<sup>13</sup> This of course is the premise of loyalty discount and bundling cases.

<sup>14</sup> Another way of putting the question is to ask whether the Firm is able to induce the input supplier to agree to the exclusive dealing only by sharing with it the fruits of the market power created or preserved by the exclusive dealing.

facility) that can be defrayed only if the Firm's sales are large enough in effect to dominate the market. It might be tempting to condemn the arrangement on the ground that the investment made no sense but for the market-dominating success. But the NES test calls for a more refined analysis. It asks whether the defendant's product could generate enough sales to make the investment profitable at competitive prices that do not reflect the demise of rivals. If so, the profitability of the investment would not depend on any price increase enabled by an increase in the Firm's market power; it would instead reflect the efficiency of the arrangement, and the arrangement would pass muster under the NES test.<sup>15</sup>

### **The Myth of Costless Exclusive Dealing**

A recent article argues that the NES test makes no sense for exclusive dealing.<sup>16</sup> Although the article is mistaken in many respects and is based in part on a misunderstanding of the NES test,<sup>17</sup> it does adumbrate an interesting argument to the effect that exclusive dealing is often costless to a dominant firm. The premise of the argument is that the dominant Firm can give input suppliers an all-or-nothing choice between dealing exclusively with the Firm or not dealing with it at all and that the input suppliers will choose exclusive dealing even if the price charged by the firm is not reduced (or, in a scenario where the Firm is buying inputs, even if the price *paid* by the Firm is not increased). The argument is not fleshed out in the article, but the logic is presumably as follows. The input suppliers obtain surplus from their dealings with the Firm. The all-or-nothing offer enables the Firm to capture some of the surplus (in the form of benefits from exclusive dealing) that the input suppliers would otherwise realize from trading non-exclusively with the Firm. The input suppliers will nevertheless accept the exclusive deal because the surplus still available to them exceeds that available from not dealing with the Firm. Thus, the argument goes, the NES test will fail to condemn exclusive dealing even where the overall costs exceed the benefits because the costs will not be borne by the Firm and will thus be neglected when the NES test is applied.

This argument is factually overstated and reflects a misunderstanding of the NES test. Exclusive dealing is costless to the Firm only if all of the following conditions are met: (i) the Firm is already dominant in the market in which it does business with the input supplier and is thus uniquely able to generate surplus for the input supplier; (ii) the Firm makes an all-or-nothing offer to only the inframarginal input suppliers who have no realistic option of rejecting it; and (iii) the Firm has no other way of discriminating among the input suppliers.

Condition (i) should be self-explanatory. Condition (ii) probably requires explanation. There is presumably a downward sloping demand curve of input suppliers demanding an

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<sup>15</sup> See A. Douglas Melamed, "Exclusive Dealing Agreements and Other Forms of Exclusionary Conduct – Are There Unifying Principles?", *73 Antitrust Law Journal* 375, 395-96 (2006).

<sup>16</sup> Jonathan M. Jacobson and Scott A. Sher, "The No Economic Sense Test Makes No Sense for Exclusive Dealing", *73 Antitrust Law Journal* 779 (2006).

<sup>17</sup> Among other things, the article asserts that the NES test would condemn exclusive dealing that enables the Firm to take sales from its competitors. But the NES test condemns exclusive dealing not because it enables the Firm to take sales from rivals (which is of course often a principal goal of lawful competition), but when its profitability for the Firm depends on creating or maintaining market power for the Firm.

opportunity to deal with the Firm.<sup>18</sup> An all-or-nothing offer would likely induce the *marginal* input suppliers – located near where the demand and supply curves intersect – to reject the offer because the offer reduces the net value of dealing with the Firm.<sup>19</sup> Also, the imposition of an exclusive dealing requirement should itself increase the number of marginal input suppliers and/or the likelihood that marginal input suppliers will reject the all-or-nothing offer because competitors of the Firm will value those suppliers more and will be willing to pay more to induce those suppliers to deal with them to the extent that exclusive dealing denies them access to other (inframarginal) input suppliers. Decisions by marginal input suppliers not to deal with the Firm would impose costs on the Firm. Moreover, to the extent that marginal input suppliers reject the all-or-nothing offer, they will be entirely available to competitors of the Firm, and the exclusive dealing arrangements will be less likely to injure competition.

Condition (iii) is critical. The no-cost argument assumes that the input suppliers are in effect realizing consumer surplus from dealing with the Firm and that they will accept the all-or-nothing offer to avoid losing the entire surplus. But dominant firms rarely if ever deal with important input suppliers by selling (or buying) off posted price lists, and they are presumably able to discriminate among input suppliers on the basis of price and other factors. (Indeed, as noted, the premise of the costless exclusive dealing argument is that the Firm can discriminate among the input suppliers by offering an all-or-nothing offer of exclusive dealing to some but not all of them.) If the Firm could engage in such price (or other) discrimination, it would be able to capture the surplus from the input suppliers without exclusive dealing.<sup>20</sup> In that event, the Firm would have no additional leverage with which costlessly to force the input supplier to agree to such an arrangement. And if the Firm could discriminate on price but chose to induce exclusive dealing instead, then the foregone gains from price discrimination would be the cost to the Firm of the exclusive dealing.

In short, exclusive dealing is likely to be costless to the Firm in only very rare situations. As a general matter, exclusive dealing imposes costs on the input supplier; it will not change the bargaining relationship between the Firm and the input supplier; and it will thus impose costs on the Firm.

Moreover, the criticism of the NES test would be misplaced even if exclusive dealing could be made costless to the Firm by means of all-or-nothing offers. The criticism is based on an understanding of the NES test that is too wooden and mechanical. The NES test is not just or even primarily an arithmetic formula. It begins with the question of whether the defendant's conduct made sense without regard to the exclusion of rivals and the creation of market power. If the defendant does not have a factually based, legitimate explanation for the conduct that excludes rivals and creates market power, the conduct will fail the NES test without any need to calculate benefits and costs. Calculations come into the picture only

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<sup>18</sup> If not – for example, if there is only one input supplier – the Firm and the input supplier would be a bilateral monopoly. In that event, the cost to the Firm of securing the exclusive dealing of the input supplier would in all likelihood reflect the opportunity cost to the input supplier of not being able to deal with third parties.

<sup>19</sup> Alternatively, individual input suppliers might have downward sloping demand curves and, if permitted by the Firm, might for example accept the all-or-nothing offer for some but not all of their facilities.

<sup>20</sup> The price discrimination could of course take the form of differential fixed fees if the Firm wanted to capture surplus without affecting the input suppliers' variable costs.

when the defendant can point to legitimate benefits but there is reason to suspect that those benefits do not justify the costs.

In the case of exclusive dealing obtained through the imposition by the Firm of an all-or-nothing offer, the first question would be whether there is a good explanation, not just for exclusive dealing, but for the all-or-nothing offer. If an input supplier rejected the offer and the Firm refused to deal with it, the question would be whether there is a good reason for the refusal to deal. If the input supplier rejected the all-or-nothing offer and countered with an offer to pay more to the Firm in order to deal with it non-exclusively, and if the Firm then rejected the counteroffer, the question would be whether there is a legitimate reason for the Firm to pass up the increased payments; at the very least, those foregone payments would be an opportunity cost incurred by the Firm. In other words, proper application of the NES test focuses on opportunity costs and inquires whether there is any aspect of the Firm's conduct that both excludes rivals and cannot be explained as furthering legitimate purposes.

The point is not that the NES test will never permit exclusive dealing that might reduce welfare overall. There might, for example, be instances in which the Firm will be able to justify an all-or-nothing policy. But the costs of such cases are likely to be far less than the transaction and error costs of other rules that might be used to determine the lawfulness of exclusive dealing.