Analysis to Aid Public Comment
In the Matter of Transitions Optical, Inc., File No. 091-0062

The Federal Trade Commission has accepted for public comment an Agreement Containing Consent Order to Cease and Desist ("Agreement") with Transitions Optical, Inc. ("Transitions"). The Agreement seeks to resolve charges that Transitions used exclusionary acts and practices to maintain its monopoly power in the photochromic lens industry in violation of Section 5 of the Federal Trade Commission Act, 15 U.S.C. § 45. Photochromic lenses are corrective ophthalmic lenses that darken when exposed to the ultraviolet light present in sunlight, and fade back to clear when removed from the ultraviolet light.

The proposed Complaint that accompanies the Agreement ("Complaint") alleges that Transitions has used its monopoly power to impose an exclusive-dealing policy on its customers since 1999. As a result, Transitions has foreclosed rivals from key distribution channels and limited competition in the relevant market, leading to higher prices, lower output, reduced innovation and diminished consumer choice.

The Commission anticipates that the competitive issues described in the Complaint will be resolved by accepting the proposed Order, subject to final approval, contained in the Agreement. The Agreement has been placed on the public record for 30 days for receipt of comments from interested members of the public. Comments received during this period will become part of the public record. After 30 days, the Commission will again review the Agreement and comments received, and will decide whether it should withdraw from the Agreement or make final the Order contained in the Agreement.

The purpose of this Analysis to Aid Public Comment is to invite and facilitate public comment concerning the proposed Order. It is not intended to constitute an official interpretation of the Agreement and proposed Order or in any way to modify their terms.

The Agreement is for settlement purposes only and does not constitute an admission by Transitions that the law has been violated as alleged in the Complaint or that the facts alleged in the Complaint, other than jurisdictional facts, are true.

I. The Complaint

The Complaint makes the following allegations.

A. Industry Background

This case involves the photochromic lens industry. Consumers of corrective ophthalmic lenses (lenses used for vision correction and worn in eyeglasses) have the option to purchase those lenses with a photochromic treatment, which protects eyes from harmful ultraviolet ("UV") light. A "photochromic lens," which is a corrective ophthalmic lens with a photochromic treatment, will darken when it is exposed to the UV light present in sunlight, and fade back to clear when it is removed from the UV light.

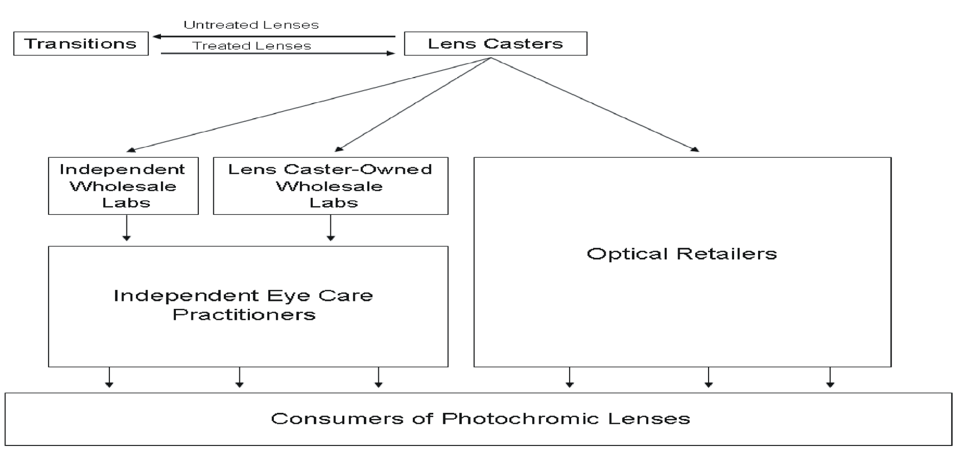
In 2008, approximately 18 to 20 percent of all corrective ophthalmic lenses purchased in the United States were photochromic, and photochromic lenses totaled approximately $630 million in sales at the wholesale level. Photochromic lenses have characteristics and uses distinct from polarized lenses (which are designed to remove glare) and fixed-tint lenses (*e.g.*, prescription sunglasses).

Transitions produces its photochromic lenses in partnership with lens manufacturers known as “lens casters.” Lens casters supply the corrective ophthalmic lenses to Transitions, and Transitions uses proprietary methods to apply patented photochromic dyes or other photochromic materials to the lenses. Transitions then sells the lenses, now photochromic, back to the lens casters. These lens casters are Transitions’ only direct customers.

Lens casters, in turn, resell the photochromic lenses to wholesale optical laboratories (“wholesale labs”) and optical retailers (“retailers”). Wholesale labs generally sell corrective ophthalmic lenses, including photochromic lenses, to ophthalmologists, optometrists, and opticians (collectively known as “eye care practitioners”) who are not affiliated with retailers. Wholesale labs grind the lens according to the lens prescription, fit the lens into an eyeglass frame, and deliver the frame with the finished lens back to the eye care practitioner. In addition to these laboratory functions, a wholesale lab will often employ a sales force to promote specific lenses to eye care practitioners. Photochromic lens suppliers, such as Transitions, use wholesale labs and their sales forces to market their lenses because wholesale labs are the most efficient means for a photochromic lens supplier to promote and sell its products to the tens of thousands of independent eye care practitioners prescribing photochromic lenses to consumers.

Retailers, on the other hand, combine both eye care practitioner and laboratory services. They employ their own eye care practitioners who deal directly with consumers. In addition, retailers grind and fit lenses into eyeglass frames and deliver the frame with the finished lens to the consumer. The retail channel is generally a more efficient means for promoting and selling photochromic lenses to consumers than comparable efforts through the wholesale lab channel because a single sales effort to a large retailer can influence the prescribing behavior of hundreds of eye care practitioners. Retailers range from large national retail chains to smaller, regional ones.

This industry structure is reflected in the diagram below.



B. Transitions' Monopoly Power

Transitions has monopoly power in the relevant market for the development, manufacture and sale of photochromic treatments for corrective ophthalmic lenses in the United States. Transitions has garnered a persistently high share of at least 80 percent of this market over the past five years, and over 85 percent in 2008. The photochromic lens industry has high barriers to entry, which include significant product development costs and capital requirements, substantial intellectual property rights, regulatory requirements, and Transitions' anticompetitive and exclusionary conduct. Direct evidence of Transitions' ability to exclude competitors and to control prices confirms Transitions' monopoly power.

C. Transitions' Conduct

Transitions has maintained its dominance, in significant part, by implementing exclusive agreements and other exclusionary policies at nearly every level of the photochromic lens distribution chain.

1. Exclusionary Practices with Direct Customers (Lens Casters)

In 1999, Corning Inc. introduced a new plastic photochromic lens, Sunsensors®, which was a direct challenge to Transitions. Transitions responded to this competitive threat by terminating the first lens caster that began selling the new SunSensors® lens, Signet Armorlite, Inc. ("Signet"), and by adopting a general policy not to deal with lens casters that sold or promoted a competing photochromic lens. Transitions furthered its anticompetitive and exclusionary efforts by, among other things: (i) entering into exclusive agreements with certain lens casters; (ii) announcing to the industry its policy of dealing only with lens casters that sold its lenses on an exclusive basis; (iii) threatening to terminate lens casters that did not want to sell its lenses on an exclusive basis; and (iv) terminating a second lens caster, Vision-Ease Lens ("Vision-Ease"), that developed a photochromic treatment, LifeRx®, to apply to its own ophthalmic lenses. Because of Transitions' course of conduct, even lens casters that have not signed exclusive agreements have a clear understanding that they cannot sell or promote a competing photochromic lens without being terminated by Transitions.

Transitions' exclusive policy is coercive to lens casters and acts as a powerful deterrent against selling a competing photochromic treatment because Transitions is such a large part of the photochromic lens market. Losing the sales generated by Transitions' photochromic lenses can jeopardize up to 40 percent of a lens caster's overall profit. Additionally, losing the ability to sell Transitions' photochromic lenses can endanger a lens caster's sales of clear lenses because many retailers and wholesale labs (and their eye care practitioner customers) prefer to buy both clear and photochromic versions of the same lens.

For all these reasons, Transitions has succeeded in foreclosing competitors from dealing with lens casters collectively accounting for over 85 percent of photochromic lens sales in the United States. These lens casters deal with Transitions on an exclusive basis and will not do business with any other suppliers of photochromic treatments.

2. Exclusionary Practices with Indirect Customers (Retailers and Wholesale Labs)

In an effort to shut out its rivals, Transitions also directed its exclusionary practices at its indirect customers: wholesale labs and retailers. In 2005, in order to mitigate the new competitive threat posed by Vision-Ease's introduction of LifeRx®, Transitions began an exclusionary agreement campaign with major retailers. Transitions induced over 50 retailers, including many of the largest chains, with up-front payments and/or rebates to enter into long term exclusive agreements that were difficult to terminate.

Transitions also has entered into over 100 agreements with wholesale labs that require the wholesale labs to promote Transitions' lenses as their "preferred" photochromic lens and to withhold normal sales efforts for competing photochromic lenses in exchange for rebates or other items of pecuniary value. Further, at least 50 percent of all wholesale labs are owned by lens casters that sell only Transitions' lenses. Because these lens casters generally use their wholesale labs to promote and sell primarily their own brand of lenses, this further impairs competitors' access to wholesale labs.

Additionally, Transitions' agreements with retailers and wholesale labs generally provide a discount only if the customer purchases all or almost all of its photochromic lens needs from Transitions. Because no other supplier has a photochromic treatment that applies to a full line of ophthalmic lenses, Transitions' discount structure impairs the ability of rivals to compete for sales to these customers. It also erects a significant entry barrier by limiting the ability of a rival to enter the market with a new photochromic treatment that applies to less than a full line of ophthalmic lenses.

Transitions' exclusionary practices with retailers and wholesale labs foreclose rivals, in whole or in part, from a substantial share – as much as 40 percent or more – of the retailer and wholesale lab distribution channels.

D. Competitive Impact of Transitions' Conduct

Transitions' course of conduct harms competition by marginalizing existing competitors and by deterring new entry. Faced with the threat of termination by Transitions, no major lens caster operating in the United States has been willing to carry the plastic SunSensors® lens since Transitions terminated Signet. Without access to effective distribution, Corning has been unable to pose a competitive threat to Transitions' monopoly, and has had little incentive to invest in research and development to improve its product. Further, some lens casters would likely develop and/or sell competing photochromic lenses, but Transitions' exclusive dealing – particularly its "all or nothing" ultimatum to lens casters – effectively deters new entrants.

Transitions' conduct at the wholesale lab and retailer levels also has harmed competition. For example, Transitions deprived Vision-Ease of access to many large retailers (one of the most efficient channels for distributing photochromic lenses to consumers), which blunted the force of its entry into the market and diminished its ability to constrain Transitions' exercise of monopoly power. Potential entrants observed Transitions' exclusionary campaign against Vision-Ease and have been deterred from entering the market.

Further, Transitions' exclusionary policies at all levels of the distribution chain deter potential competitors from entering the market on an incremental basis. Transitions' "all or nothing" policy with lens casters deters them from purchasing or developing a competing photochromic treatment that can be applied to less than a full line of ophthalmic lenses because the lens caster is unlikely to be able to recoup the substantial profits it would have made from the sale of the full line of Transitions' products. Similarly, the structure of Transitions' discounts to retailers and wholesale labs – which are generally conditioned on the customer's purchase of all or almost all of Transitions' products – places competitors with less than a full line of photochromic lenses at a disadvantage when competing for this business.

Transitions' exclusionary practices have likely increased prices and reduced output. For example, because it does not face effective competition, Transitions has been able to ignore consumer demand and refuse to supply its low-priced, private label photochromic lens in the U.S. market, even though Transitions offers this product in other markets.

Transitions' conduct has also harmed consumers by depriving rivals of the incentive to innovate and to develop competing photochromic lenses. If faced with more competition, Transitions would also likely have a greater incentive to invest additional resources in research and development.

There are no procompetitive efficiencies that justify Transitions' conduct or outweigh its substantial anticompetitive effects.

II. Legal Analysis

Exclusive dealing by a monopolist is condemned under Section 2 of the Sherman Act, 15 U.S.C. § 2, when the challenged conduct significantly impairs the ability of rivals to compete with the monopolist and thus to constrain its exercise of monopoly power.[1] Agreements that foreclose key distribution channels are often found to have this proscribed effect and are deemed illegal.[2]

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[1] *See, e.g., Aspen Skiing Co. v. Aspen Highlands Skiing Corp.*, 472 U.S. 585, 605 & n.32 (1985) (exclusionary conduct "tends to impair the opportunities of rivals" but "either does not further competition on the merits or does so in an unnecessarily restrictive way") (citations omitted); *Lorain Journal Co. v. United States*, 342 U.S. 143, 151-54 (1951) (condemning newspaper's refusal to deal with customers that also advertised on rival radio station because it harmed the radio station's ability to compete); *United States v. Microsoft Corp.*, 253 F.3d 34, 68-71 (D.C. Cir. 2001) (condemning exclusive agreements because they prevented rivals from "pos[ing] a real threat to Microsoft's monopoly"); *United States v. Dentsply Int'l, Inc.*, 399 F.3d 181, 191 (3d Cir. 2005) ("test is not total foreclosure but whether the challenged practices bar a substantial number of rivals or severely restrict the market's ambit"); *LePage's, Inc. v. 3M*, 324 F.3d 141, 159-60 (3d Cir. 2003) (same).

[2] *See, e.g., Microsoft*, 253 F.3d at 64 (condemning exclusive agreements that foreclosed rivals from "cost-efficient" distribution channels); *LePage's*, 324 F.3d at 159-60 (finding "exclusionary conduct cut LePage's off from key retail pipelines"). *See also* Richard A. Posner, ANTITRUST LAW 229 (2d ed. 2002) (noting that exclusive dealing may "increase the scale necessary for new entry, and . . . increase the time required for entry and hence the opportunity for monopoly pricing").

The factual allegations in the Complaint are consistent with a finding of monopoly power and competitive harm. Transitions' policy of requiring exclusivity from its lens caster customers has foreclosed its rivals from over 85 percent of available sales opportunities at this level of the distribution chain. This foreclosure is particularly significant because nearly all photochromic lenses are first sold by lens casters – attempts to fabricate photochromic lenses at the wholesale lab or retailer level have largely been abandoned as uneconomical. The competitive impact of this exclusive dealing with lens casters is amplified by Transitions' exclusionary practices with retailers and wholesale labs, which further foreclose rivals, in whole or in part, from as much as 40 percent or more of these downstream distribution channels. Transitions' exclusionary conduct has thus likely caused higher prices, lower output, and reduced innovation and consumer choice.

A monopolist may rebut a such a showing of competitive harm by demonstrating that the challenged conduct is reasonably necessary to achieve a procompetitive benefit.[3] Any proffered justification, if proven, must be balanced against the harm caused by the challenged conduct.[4]

No procompetitive efficiencies justify Transitions' exclusionary and anticompetitive conduct. Transitions cannot show that the exclusive arrangements were reasonably necessary to achieve a procompetitive benefit, such as protecting Transitions' intellectual property or technical know-how, or preventing interbrand free-riding.[5] Transitions does not transfer substantial intellectual property or technical know-how to its customers, and even if it did, any such transfer would likely be protected by existing confidentiality agreements.

A concern about interbrand free-riding also does not justify the substantial anticompetitive effects found here. The vast majority of Transitions' promotional efforts are brand specific, reducing the significance of any free-riding concern.[6] While Transitions' marketing efforts may generate some consumer interest in the product category as a whole – and not just in Transitions' own products – this is a part of the natural competitive process. This type of consumer response does not raise a free-riding concern sufficient to justify the substantial anticompetitive effects found here.[7]

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[3] *E.g., Microsoft*, 253 F.3d at 59.

[4] *Id.*

[5] "Interbrand free-riding" occurs when a manufacturer provides services, training, or other incentives in the promotion of its products for which it cannot easily charge its dealer, and that dealer "free-rides" on these demand-generating services by substituting a cheaper, more profitable product made by another manufacturer that does not invest in comparable services. *See generally* Howard P. Marvel, *Exclusive Dealing*, 25 J.L. & ECON. 1, 8 (1982).

[6] *See United States v. Dentsply Int'l, Inc.*, 277 F. Supp. 2d 387, 445 (D. Del. 2003), *aff'd in rel. part*, 399 F.3d at 196-97; Marvel, *Exclusive Dealing*, 25 J.L. & ECON. at 8 (explaining that an interbrand free-riding justification "does not apply if the promotional investment is purely brand specific. In such cases, the dealer will not be in a position to switch customers from brand to brand.").

[7] *See In re Polygram*, 136 F.T.C. 310, 361-62 (2003), *aff'd,* 416 F.3d 29, 37-38 (D.C. Cir. 2005).

III. The Order

The proposed Order remedies Transitions' anticompetitive and exclusionary conduct and imposes certain fencing-in requirements that are designed to prevent *de facto* exclusive dealing.[8] Paragraph II of the Order addresses the core of Transitions' exclusionary conduct and seeks to lower entry barriers and to restore competition. Paragraph III requires Transitions to implement an antitrust compliance program, which includes providing notice of this Order to Transitions' customers. Paragraphs IV-VI impose reporting and other compliance requirements. The Order expires in 20 years unless otherwise indicated.

Paragraph II.A prohibits Transitions from adopting or implementing any agreement or policy that results in "exclusivity" with lens casters, or its "Direct Customers." "Exclusivity" is defined in the Order to include any requirement that a customer limit or refrain from dealing with a competing photochromic lens, as well as any requirement that a customer give Transitions' products more favorable treatment as compared to a competitor's products.

Paragraph II.B allows Transitions to enter into exclusive agreements with retailers and wholesale labs ("Indirect Customers"), provided certain safeguards are met. Specifically, any exclusive agreements with Indirect Customers must: i) be terminable without cause, and without penalty, on 30 days written notice; ii) be available on a partially exclusive basis, if requested by the customer; and iii) not offer flat payments of monies in exchange for exclusivity. These provisions, along with Paragraph II.E, which prohibits Transitions from bundling discounts, are designed to enable a competitor or entrant to compete for a customer's business, even if it does not offer a photochromic treatment that applies to a full line of ophthalmic lenses. Creating conditions conducive to effective entry on an incremental basis is likely to hasten new entry and to restore competition.

Under Paragraph II.C, Transitions may not limit its customers from communicating or discussing a competing photochromic lens with consumers and others. This Paragraph also requires Transitions to allow a lens caster or another customer that sells Transitions' photochromic treatment on a particular brand of lens to sell a competitors' photochromic treatment on the same brand.

Paragraph II.D has two provisions designed to prevent *de facto* exclusive dealing through pricing policies. First, Transitions cannot offer market share discounts, *i.e.*, discounts based on the percentage of a customer's sales of Transitions' lenses as a percentage of all photochromic lens sales. Second, Transitions cannot offer discounts that are applied retroactively once a customer reaches a specified threshold. For example, Transitions may provide a discount on sales beyond 1000 units but it may not lower the price of the first 999 units if and when the customer buys the 1000th unit. The provisions in Paragraph II.D, along with Paragraph II.E, will be in effect for 10 years.

Notwithstanding any provision of the Order, Paragraph II.G explicitly allows Transitions to provide volume discounts that reflect certain cost differences, and to offer discounts to meet

[8] We use the term "*de facto* exclusive dealing" to refer to practices that significantly deter a customer from purchasing or selling a competing photochromic lens.

competition. It also allows Transitions to require that any monies it provides to customers be used solely for the manufacture, promotion or sale of Transitions lenses.

Finally, Paragraph II.F prohibits Transitions from retaliating against a customer that purchases or sells Transitions lenses on a non-exclusive basis.