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Lear Competition Note

WHICH TEST FOR BUNDLED DISCOUNTS

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The motivations for bundled discounts

Bundled discounts, multiple rebates and mixed bundling are synonymous. They describe situations when a multi-product firm offers a bundle of products for a lower price than the combined cost of purchasing all the products in the bundle separately.

Bundled discounts are a form of price cutting, which are presumptively beneficial to consumers.

Indeed there are a number of pro-competitive, or competitive-neutral, reasons that explain why firms offer bundled discounts as opposed to single product discounts: the discount may reduce consumers' search and transaction costs, it can allow a firm to exploit economies of scale and scope and pass them to its customers, it can be a form of price discrimination aimed at expanding output to the benefit of the consumers[1] and it can be used to increase the take-up of innovative products.

Yet, when these bundled offers come from a firm which is dominant in the production of one of the goods included in the bundle, there is a fear that it may be exploiting this market power to foreclose competitors, thus harming consumers. The economic literature has identified two main anticompetitive reasons for bundling. First, the bundle may represent an offensive strategy aimed at leveraging the incumbent's market power into another market or, second, it may be a defensive strategy for protecting the monopolized market.[2]

This implies that the discount that accompanies the bundled offer has to be carefully evaluated before it is possible to determine if it represents a legitimate strategy or not.

The price-cost test and the potential exclusionary effects of bundled discounts

The Guidance Paper recently released by the European Commission (hereafter: the Commission) on "Enforcement Priorities in applying Art. 82 for exclusionary abuses"[3] and the report issued by the US Department of Justice (hereafter: the DoJ) on "Single-Firm conduct"[4] set out a framework to analyze the potential exclusionary effects of bundled discounts from dominant firms. The Commission and the DoJ share a similar approach that envisages two steps: (i) assessing the type of competition faced by the dominant undertaking (whether this is bundle-to-bundle or on single products); and (ii) assessing the impact of the discount applying, according to the outcome of the first step, a predatory-style test or an implicit price-cost test.

The first step of the analysis consists in assessing whether the bundled offers of the dominant firm are competitively constrained by similar packages supplied by rivals or only by stand-alone offers. If bundle-to-bundle competition is sufficiently developed, as most firms offer bundles or would be able to do so easily, then the analysis should mirror that followed in predatory cases[5]:the price of the bundle should be compared with an appropriate measure of the cost of the entire bundle. Whereas, when one or more products in the bundle are monopolized, rival firms cannot provide the same bundle as the dominant firm and, thus, bundle-to-bundle competition is not possible. In this case, an implicit price-cost test should be applied

Implicit price-cost test

If competition is between the bundle offered by the dominant firm and the single-product offers of its competitors, the latter firms must provide the entire value of the discount the incumbent offers on the bundle on their narrower product offerings. In other words, considering a two-product bundle, the competitor must charge a price for the competitive product such that a customer is at least indifferent between purchasing the bundle from the dominant firm and buying the monopolized product from the dominant firm and the competitive product from the rival.

Such price, which is called *implicit or imputed or incremental*, is the price that compensates a customer for not buying the bundle from the dominant undertaking. It is calculated by taking the price of the bundle and deducting from it the stand-alone price of the monopolised product.

Once the implicit price has been calculated, this test works like the predatory one, in that it compares the implicit price with a measure of the costs of the stand-alone product. The Commission and the DoJ identify the LRAIC (Long Run Average Incremental Cost)[6] as the relevant cost benchmark. If the implicit price for the competitive product is below the LRAIC of supplying that product, a competitor could not match that price and, thus, the bundled strategy may generate exclusionary effects.

Some issues in the implementation of the implicit price-cost test

The Commission's Guidance Paper and the DoJ report provide valuable indications for the competitive assessment of bundled discounts. However, they do not settle all the issues that arise when these practices have to be assessed.

This note focuses on two aspects that we believe are of particular relevance in the implementation of the price-cost tests and which have not been addressed neither by the DoJ, nor by the Commission: the assessment of the type of competition (whether bundle-to-bundle or single product) and how to allocate the discount across products when the bundle includes more than two goods.

How to assess the type of competition

We pointed out above that the standard of proof varies with the type of competition faced by the dominant undertaking and different standards of proof may lead to opposite conclusions on the potential risk of foreclosure raised by bundled discounts.

Example 2

Suppose that a dominant firm sells a monopolized product (product A) and two competitive products (product B and product C). The incremental cost of producing the goods is 3€ for product A and 4€ for both product B and product C. Further, assume that there are no common or joint costs. The stand-alone price is 10€ for product A, 6€ for product B and 7€ for product C. The firm offers a 4€ discount on the bundle if customers purchase the three products together. The situation is presented in the table below:

	A	B	C	Bundle ABC	**Bundled discount**
Price	10	6	7	19	**4**
Incremental cost	3	4	4	11	

Under the DoJ approach, the implicit price of the sub-bundle of the two competitive products is given by the sum of their stand-alone prices (6 + 7 = 13€) minus the entire bundle discount (4€) and thus amounts to 9€. This must be compared with the incremental cost of producing the two products, which is 8€ (= 4 + 4). The pricing scheme passes the test, as the implicit price of the competitive sub-bundle exceeds the relative incremental costs.

Under the Commission standard, in order to calculate the implicit price one should attribute the entire discount to each competitive product at a time. Hence, the implicit price of product B is 2€, which is given by the difference between its stand-alone price and the bundled discount. Similarly, the implicit price of product C is 3€. Both competitive products fail the test as their implicit prices lie below the relative incremental costs.

The DoJ states that the discount should be attributed to all the competitive products jointly, regardless of whether the plaintiff, or any other rival, produces all the competitive products. The rationale is that, since the non-monopolized goods are competitive, *a rival could offer these goods in a package even if the rival did not itself produce* all these goods. The presumption behind this statement is that equally efficient producers of competitive goods can always team together and jointly offer a package that replicates the dominant undertaking's one.[7]

The DoJ's rule is easy to apply (because no further reallocation of the discount is necessary) and lowers the risk of false positive. Yet, it does not account for situations where there are no competitors producing the whole range of competitive products and a joint-supply agreement may be hard to reach. Thus, it might penalize firms that only sell one product.

The Commission takes an approach which lies at the other extreme, it attributes the entire discount to each of the products in the dominant undertaking's bundle. This approach guarantees the protection of single-product firms, but it may impose too high a floor to legitimate and beneficial-to-consumer price reductions, since the discount is counted more than once. Hence there is a risk of chilling pro-competitive price cuts.

Overall, neither the Commission nor the DoJ standards appear to be completely satisfactory, as each one may lead, respectively, to over-or under-deterrence. Alternatives approaches have been proposed, but they are not convincing either.

For example, the New Zealand Commerce Commission, in an investigation concerning bundle offers in the telecoms sector, attributed the discount to each of the competitive products in the bundle in proportion to the revenues earned by the incumbent from its stand-alone sales of the corresponding products.

This allocation rule represents an attempt to allocate the discount across all the competitive products, however it has the limitation that it does not seem to be based on any clear economic principle.

In general, the replicability of the dominant firm's bundled offers by single-product firms depends on their ability and their incentive to reach an agreement on how to share the burden of the entire discount among themselves. Consider a dominant firm selling a bundle of three products, one monopolized (A) and two competitive (B and C).

To replicate the dominant firm's bundled offers, single-product competitors of the competitive goods must lower their prices up to the point where a customer is indifferent between purchasing the bundle from the dominant undertaking or buying the three products separately. The total reduction in the prices of the two competitive products, thus, must match the entire value of the bundled discount. In principle, therefore, competitors have conflicting interests because each one would like the other to contribute more to this reduction.

This raises the question of how best they can share the burden of the overall reduction in prices needed to match the bundled discount. An accurate analysis of the features of the relevant markets that may affect the incentive to collaborate can then help in developing a more refined economic approach to allocate the discount across competitive products.

Final remarks

The Commission's Guidance Paper and the DoJ report set out a two-step approach to analyse the potential foreclosing impact of bundled discounts by dominant firms. Even though these two documents represent an important step towards the development of a general framework for assessing bundled pricing schemes, a number of aspects need to be further developed. This note highlights two issues relative to the implementation of the price-cost test, namely the evaluation of the nature of competition in the relevant markets and the rule to allocate the discount across the products when bundle-to-bundle competition is not possible.

It is however important to emphasise that the price-cost test tells only part of the story. Two conditions, indeed, must hold to establish that an exclusionary behaviour is in breach of art 82: foreclosure and consumer harm. Neither is sufficient by itself, but both are necessary. In other words, both have to be proved for a conduct to be deemed abusive, whereas it is sufficient to disprove one to conclude that a conduct is compatible with Article 82, or similar rules against anticompetitive unilateral conducts.

The price-cost test provides an indication on whether the dominant firm's strategy is replicable by competitors and, thus, whether it may lead to foreclosure. No conclusions, however, can be drawn from the test about the potential harm to consumers resulting from the concerned conduct. In other words, the test is a tool to detect exclusionary effects and hence, it represents only the first step in the overall evaluation of bundle strategies. It plays an important role, though. If passed, it may be conclusive in ruling out exclusionary allegations where competitors are not at risk of foreclosure, thereby avoiding complex assessments of the effects on consumer welfare.

Notes

[1] See G. J. Stigler (1963), United States v. Loew's Inc.: a note on block-booking, The Supreme Court Review, 152.

[2] The rationale is that through bundling a dominant firm would force a rival, who is willing to start selling the monopolized product, to enter more markets at the same time to be able to compete. This may raise the cost of entry and increase the risk of failure, thereby making entry less likely.

[3] EU Commission (2008) "Guidance on the Commission's Enforcement Priorities in Applying Article 82 EC Treaty to Abusive Exclusionary Conduct by Dominant Undertakings".

[4] U.S. Department of Justice (2008) "Competition and Monopoly: Single-firm Conduct under Section 2 of the Sherman Act".

[5] The analysis of an alleged predatory behaviour differs in the two jurisdictions. In the US the plaintiff is required to show a dangerous probability of recoupment, whereas in the EU recoupment is presumed when a firm is dominant. A detailed examination of the differences in these two predatory tests and of their possible implications is beyond the scope of this note.

[6] The Commission defines the LRAIC as "*the average of all the (variable and fixed) costs that a company incurs to produce a particular product*".

[7] As long as the implicit price of the competitive products as a whole is above the incremental costs of producing the two and competitors are as efficient as the dominant undertaking, there is always a combination of stand-alone prices of the competitive products that can match the bundle offer and still be profitable.