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Tying and bundling – cause for complaint?

This Brief explores some economic and policy issues raised by tying and bundling in the context of abuse of dominance investigations, focusing in particular on the role that third party complaints play in the analysis. Interest in the treatment of this subject under European competition law has recently been renewed by the Commission's decision in the Article 82 case against Microsoft.[1]

What is bundling?

Bundling arises where two products, A and B, are provided together as a take-it-or-leave-it proposition, with no option to buy A or B separately.[2] In competition law contexts, bundling cases often involve the combination of a "monopoly" and a "competitive" product, but bundling is commonly observed even where the supplier in question does not enjoy market power over either element in a bundle. Indeed, any manufacturing activity can be seen as a form of "bundling" of the component parts. A simple ball-point pen is a "bundle" of the pen's cap, casing and the ink refill contained within it.

The fact that bundling is ubiquitous underlines an important conclusion. There can be no economic sense in a per se rule "against" bundling because bundling is an activity that is engaged in by all firms. If a policy of outlawing bundling was enforced rigorously, this would have the perverse and unintended effect of making it illegal for dominant firms to engage in any manufacturing process.

Competition law, however, has not generally appreciated this. Instead, legal commentaries are predicated on the assumption that bundling invites justifiable suspicion, and agonise over questions such as where one product ends and another begins, or when the combination of two products has a "legitimate business purpose" or an "objective business justification". In a recent article, Microsoft's European antitrust counsel provided a defence of Microsoft's "bundling" of Windows and Media Player with an argument that rested heavily on the proposition that computer software is more akin to shoes and shoelaces (i.e. good bundling) than nails and nail guns (i.e. bad bundling).[3]

More recently, in the ILCU case before the Irish High Court under Section 5 of the Irish Competition Act, the parties engaged in a lengthy (but inherently fruitless) debate on how the SSNIP test could be used to test whether the services offered by the ILCU to its members were a single offering or a bundle.[4] The SSNIP test cannot be used for this purpose because it is designed to test the closeness of competition between substitute products. It has nothing to say on how to judge whether two components form a single product or a bundled pair of products.

Given the state of the law, and the high stakes involved, it is entirely understandable that advocacy effort is poured into inventing and sustaining distinctions between where one product ends and another begins, but the task is a futile one. The fact that there is no "objective" line between these propositions has been acknowledged in the economic literature at least since the work of Coase on the theory of the firm in 1937.[5]

An approach that says bundling is acceptable by dominant firms as long as they can provide an "objective justification" does not hold the solution to this problem either. The assumption behind this approach is that it may be possible for the dominant firm to cancel out the harm it has done through bundling if it can find an offsetting efficiency advantage. Although

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Case Comp/C-3/37.792 Microsoft, 24 March 2004.

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This is pure bundling. A weaker form – so-called "mixed bundling" – arises where the bundled offer is made available at a discount to the sum of the prices of the components, i.e. where the price of [A+B] is less than the price of A + the price of B.

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Jean-Yves Art and Gregory v S McCurdy, "The European Commission's Media Player Remedy in its Microsoft Decision: Compulsory Code Removal Despite the Absence of Tying or Foreclosure", ECLR 2004, Volume 25, Issue 11, pp 694-707. The bundling of nails and nail guns is assumed to be an instance of "bad bundling" because these were the elements involved in the Article 82 decision against Hilti. Elsewhere, however, the Hilti decision has been widely criticised even by economists who are generally hawkish on the adverse effects of bundling (See, for example, Nalebuff, "Bundling, tying and portfolio effects, part 2: case studies", DTI Economics Paper No 1, February 2003).

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High Court Judgment [2003 No 8608P], The Competition Authority v John O'Regan and others, 22 October 2004.

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Ronald Coase, "The Nature of the Firm" (1937). Coase was awarded the Nobel Prize in Economics for his work in this area and the related concepts of contracts and transactions costs in 1991.

the use of a rebuttable presumption against acts of bundling would be less perverse than the per se approach, it still places a burden of proof against normal commercial activity that has no justification in economics.

A more rational approach to bundling is to identify the circumstances in which bundling can have adverse effects on competition, and then to work on operational rules that might help to distinguish these harmful cases from the generality of normal commercial behaviour. This approach would be consistent with the general shift towards effects-based enforcement, and would reduce the risk of finding beneficial behaviour to be unlawful.

What harm can bundling do?

Whilst the Chicago School economists long ago showed it was a fallacy to imagine that market power is automatically extended from A to B simply by bundling the two products, there now exist numerous "Post-Chicago" theoretical models of possible harm from bundling. Increasingly, these models predict that bundling can harm competition by protecting monopoly power from the threat of future challenge.[6] Consider a decision by a firm that was dominant in manufacturing to make its product available to consumers only through its own retail outlets. That might enable the dominant firm to prevent the emergence of a strong independent retail sector that could, over time, have provided a springboard for establishing a new rival for the dominant firm's position in manufacturing. By using bundling to create a kind of "exclusion zone" around the source of the firm's monopoly position, that monopoly can be made more secure.

In the US case against Microsoft (the "Windows Explorer" case), the DOJ's theory of competitive harm relied on the belief that the development of Netscape as a vigorous independent player in the browser market could over time act as a platform for a rival to Microsoft's stronghold in PC operating systems.[7] In the more recent EC case against Microsoft's bundling of Windows and Media Player, similar arguments have been advanced in the context of Real Networks as a possible focal point for the development of "middleware" that could eventually challenge the Windows operating system.[8]

One of the factors that makes it hard to apply post-Chicago theories on bundling is that they invariably rely on some strategic story, and thus carry a trade-off between short term consumer gains and the fear of longer term abuse. This is seen clearly in the Microsoft cases, where the short term gain to consumers from having (respectively) the Windows Explorer and Media Player products bundled free of charge with any purchase of the Windows operating system has to be weighed against the possibility of longer term harm if the act of bundling means that some future potential challenge to Microsoft's position as a dominant operating system supplier could thereby be rendered ineffective.

The speculative nature of the competitive harm is problematic. The risk of regulatory error is magnified by the fact that these cases are often initiated not by customer concerns, but by the competitors who fear they will be excluded from the market by the dominant firm's actions.

Competition or competitors?

When they apply, theories of monopoly power protection through bundling usually predict harm to the competitive process (hence the consumer) by denying individual competitors economies of scale, network effects or appropriate incentives to innovate. This means that the inevitable claim of the dominant firm that the case against bundling mistakenly "protects competitors, not competition" can become an empty slogan.

6 There are also models of monopoly power extension. The concern with bundling is usually foreclosure, although in theory bundling may dampen competition or be a tool for exploitation.

7 In brief, the idea is that applications (such as word processing and spread sheet programmes) could exploit the building blocks (APIs) provided by Netscape in place of those provided Microsoft's operating system. Since Netscape was available for most operating systems, this would have permitted applications that were previously available only for the Microsoft platform to run on all those systems. As a result, the Microsoft operating system could have lost the advantage of being the only system for which most applications are written.

8 The other aspect of the EC Article 82 case, relating to inter-operability information between Windows and server software, is harder to characterise. The Commission's concern in this case may have been more to do with extension of market power from PC to server software.

The problem is that the damage to those individual competitors is not in itself a good measure of the long term harm to competition, because the exclusion of such firms is just one element of the harm that anti-competitive bundling might eventually do. For example, if the actions of Microsoft forced RealNetworks to withdraw its product from the market, there could be some damage to individual consumers who strongly prefer the RealNetworks player to the Microsoft product. However, if one subscribes to the monopoly power protection theory behind the Microsoft media player case, the real damage to consumer interests does not arise from the lack of (current or future) choice of media players, but from the fact that this exclusion would ultimately prevent consumers from benefiting from the emergence of a rival to Microsoft's monopoly position in PC operating software.[9]

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Moreover, if this loss of choice justified intervention the same would need to hold true for all the other (implicit) choices denied by the way Microsoft bundles hundreds of other functions within the Windows operating system codes.

These finer points do not deter complainants from objecting to the exclusionary effects of bundling, because their incentive to complain is driven by the immediate effects they suffer, not by the ultimate consumer impact. Complainants have a clear commercial incentive to object even when bundling by the dominant firm has positive benefits to consumers. More sophisticated complainants could tailor their complaints to fit the framework of one of the post-Chicago theories of competitive harm to maximise the chance of their complaint being upheld by a consumer-focused competition authority.

It is interesting to view the Article 82 case law on bundling in the light of these observations. It is notable how almost all instances, including such prominent cases as Commercial Solvents, Hugin and Sealink, have been motivated by a vociferous complainant or group of complainants whose existing operations have been bypassed by the dominant firm's decision to cut them out of the supply chain though integration into the "competitive" activity. In contrast, one needs to go to the regulated and formerly state-controlled natural monopoly network industries such as gas, electricity and telecoms to find cases where intervention has led to unbundling (in some cases full blown disintegration) on the initiative of the regulator.

The over-reliance of competition law intervention on vigorous complainants who have been wronged by the perceived extension of market power after a competitive operator has been cut out of the supply chain is starkly illustrated by the Genzyme case under the UK's Chapter II prohibition of dominant firm abuse.[10] Genzyme bundled its monopoly product (a specialist pharmaceutical product) with home care and delivery services, charging a single price for the integrated product. It then terminated the sub-contracting agreement it had with a third party provider of home care services, deciding instead to provide those services in-house. The sub-contractor promptly complained to the OFT about this act of exclusion.

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See RBB Brief 10, "The Genzyme Case and the OFT's Margin Squeeze Muddle", for a fuller discussion of the OFT's approach to bundling in this case.

In its decision, the OFT concluded that Genzyme's practice of bundling the product with the home care services was an abuse, and that the abuse had existed even when Genzyme had used the third party as a sub-contractor. But on appeal, the Competition Appeals Tribunal determined that the abuse arose only in the period after Genzyme had terminated the third party service contract. Even though Genzyme's policy of offering a bundled price for the product was consistent throughout, that act was deemed to be an abuse only after a complainant emerged. It is hard to justify this distinction based on any approach that relies on the adverse economic effects of bundling. Either the bundling was always harmful, or it was benign. The emergence of a complaint in itself cannot suddenly make benign behaviour harmful.

If the existence of complainants is capable of skewing the competition law analysis to such a degree, it is no surprise to see dominant firms taking steps to appease complainants, even where it is inefficient to do so. In general this might be achieved by dominant firms holding back from implementing product innovations that could upset competitors or existing trading partners even if they would benefit consumers. In the specific circumstances of the Microsoft case, it appears to have taken the form of side payments made by Microsoft to complainants in return for them agreeing to terminate their participation as complainants before the European (and other) competition authorities.

If the competition case against Microsoft's conduct is sound, there is no reason why such "settlements" should have any bearing on the vigour with which the Commission pursues its case before the European Courts, since the settlement deals only with the incidental effect of the abuse (the harm to competitors) without doing anything to address the real consumer detriment (the harm to competition). If Microsoft's payments are seen as a "correction" to avoid an unhealthy complainant-led distortion in the way in which bundling cases are pursued, they can perhaps be seen in a more favourable light. However, payments by dominant firms to buy off rivals in this way are very distinct from solutions in which the dominant firm undertakes to stop an abusive practice. They could set an unhealthy precedent if they compromised the ability of the Commission to carry out its investigations of complex industries.

Conclusions

A rational economics-based policy on the enforcement of competition law against bundling by dominant firms is hampered by a basic misconception that the act of bundling is a well-defined (and presumptively abhorrent) practice. There is an urgent need to recognise that bundling is no more nor less than the practice of combining ingredients into a single product offering. That is normal commercial behaviour, and indeed an inevitable part of virtually any value-added activity. Effort spent on arguing over where one product ends and where a "bundle" begins is at best wasted, and more often than not is actually harmful to finding sensible consumer-serving competition policy outcomes.

A valid case against bundling as an abuse requires something more substantive than name-calling. In order to focus intervention against those instances where bundling is harmful to consumers and economic efficiency, it is necessary to identify the applicable theory of exclusion or monopoly power protection, and to test that theory critically against the facts. Most important of all, the assessment of those concerns needs to recognise that, whilst adverse outcomes for consumers can result from the exclusion of competitors, the incentive for rivals to complain bears no reliable relationship to the risk that the practice will harm competition.