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# Article 82: Tying and bundling

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# Article 82: Tying and bundling

## A half step forward?

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The delay in releasing the article 82 discussion paper (the Discussion Paper) is thought to have been determined by the much awaited judgment by the CFI in *GE/Honeywell*. Bundling and tying were a major issue in the appeal and therefore the Commission needed to ensure some degree of consistency with the court's view on bundling.

The Commission might also have expected some guidance from the judgment. However, the *GE/Honeywell* judgment cannot be considered the "Airtours of conglomerate effects", as might have been hoped for. While confirming that, in conglomerate mergers, the Commission should carefully consider the incentives to engage in bundling, the CFI did not clearly specify under which circumstances foreclosure effects could arise from bundling in the case of complementary products.The Commission therefore had no clear economic guidance to draw on from the recent case law. Rather, the Commission could only rely on a limited jurisprudence and recent, and constantly developing, economic literature on the exclusionary effects of bundling and leveraging. In that context, designing a unified framework was always going to be arduous.

### The Discussion Paper's new test

The Discussion Paper starts by defining three main types of practices involving selling products together: tying, pure bundling and mixed bundling.

"Tying" occurs when the purchase of product A (the tying product) is conditional on the purchase of product B (the tied product) but where A cannot be purchased alone, while B can. For example, cable operators often offer a basic package alone (the tied product, B) but premium channels (the tying product, A) cannot be purchased without the basic package. "Pure bundling" refers to a situation where products A and B can only be purchased together. This is the case, for example, when buying a business class ticket on the Eurostar, which includes a meal. Transport and meal can only be purchased together. "Mixed bundling" is where A and B can be purchased separately but purchasing them together is cheaper (there can be more than two products). This is what the Commission also refers to as "commercial tying" (see para 182 of the Discussion Paper).

The Commission recognises the basic principle (see para 178) that these practices are widespread and generally devoid of anticompetitive effects. Bundling and tying by a dominant firm can, however, lead to foreclosure effects (ie exclusion of as-efficient competitors). Note that the Commission mentions that bundling and tying can also lead to price discrimination and higher prices but these potential effects are not covered by the Discussion Paper (see para 179).

According to the Discussion Paper, tying and bundling may have exclusionary effects when four conditions are satisfied: (1) there is pre-existing dominance; (2) the two (or more) products that are tied or bundled are distinct; (3) the practice is likely to have a foreclosure effect; and (4) there is no efficiency or objective justification for the practice. Foreclosure may arise because bundling causes demand to be shifted away from competitors, and may gradually lead to the marginalisation and potentially the exit of competitors (see further para 180 of the Discussion Paper). The four conditions are discussed in greater detail below.

#### *Dominance*

The first condition for exclusionary effects to arise requires dominance in the tying market (in the case of tying) while, in the case of mixed bundling or pure bundling, there should be dominance in at least one of the product markets that are part of the bundle.

#### *Distinct products*

The products to be tied or bundled should be distinct. The Commission proposes a demand test to identify whether customers have independent demands for each product (Would customers purchase each product separately if available?) as well as supply tests (Are smaller competitors offering the products separately or are there manufacturers specialising in the production of the tied good only?).

#### *Foreclosure effects*

As indicated above, foreclosure effects may arise as demand is shifted away from competitors. The size of demand being tied and the identity of customers being tied will constitute determining factors in assessing the potential for foreclosure. "Tied demand "is defined as demand for which "rivals cannot compete" (see para 188).

Market distorting foreclosure becomes more likely if tied customers represent a large proportion of the tied market. The identity of tied customers will also be relevant (in terms of their importance for successful entry). Scale economies, network effects and barriers to entry in the tied market will all contribute to strengthening potential foreclosure effects.

On the other hand, product differentiation in the tied market can help to limit foreclosure effects if customers have a strong preference for the products of competitors. The ability and incentive of rivals to offer competing bundles (counter-strategies) will also weaken the potential for foreclosure effects. Reactions by customers (eg the ability to sponsor entry) will be taken into account. The market performance of the dominant firm and its rivals in the tied market may also indicate whether

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there are possible foreclosure effects (ie how have market shares evolved after the practices were implemented?).

In the case of mixed bundling, an additional predation-like test is proposed: the incremental price of an additional product in a bundle should at least cover the long run incremental cost of supplying that bundled product. The incremental price takes into account the discounts implied by adding products to the package purchased from the dominant firm. The reason for choosing the long run incremental cost as the relevant cost benchmark is that it "captures the extra costs of the dominant company's activities in the market(s) in which it is not dominant" (see para 190).

### *Efficiencies*

Finally, the Commission will consider efficiency justifications for the bundling strategies. Efficiencies include transaction cost savings or production / distribution cost savings. The Commission suggests (see para 205) that technical bundling may be more convincing in an efficiency defence, particularly where the products bundled are likely to become an integrated product in the future: While deemed acceptable in principle, quality and safety reasons for bundling will be considered cautiously by the Commission.

## A better way to appraise bundling?

On tying and bundling, the Discussion Paper offers useful clarification and represents a good starting point for the analysis of exclusionary bundling. Unfortunately, however, some areas of the analysis advocated by the Commission remain incomplete and certain insights from the economic literature have also been overlooked. The remainder of this article discusses how the Discussion Paper improves the analysis of exclusionary bundling and elaborates on the aspects that should be further developed in the next round of reform.

### *The improvements*

■ **The pro-competitive motives for bundling.** The tying and bundling section of the Discussion Paper signals a welcome change in direction in the analysis of bundling and tying. While EU case law on these practices is relatively limited, a per se approach to tying by dominant firms was generally held to apply. The Discussion Paper recognises that specific circumstances are necessary for foreclosure effects to arise from bundling and tying (a line consistent with recent case law on conglomerate mergers). Indeed, the Discussion Paper departs from previous practice by recognising that bundling – even by dominant firms – often has procompetitive motives. In recognising such motives, the Discussion Paper advances the debate on leveraging of market power through tying/bundling further than the CFI did in the *Tetra Laval/Sidel* and *GE/Honeywell* judgments. Indeed, the CFI judgments relied partly on the the deterrent effect of article 82 to reduce the incentives of engaging in tying or bundling, as these practices could be deemed abusive (in line with the jurisprudence's presumption that tying/bundling by dominant firms is generally anticompetitive).

■ **Clear dominance is required.** The Discussion Paper is consistent with economic theory in that it recognises that exclusionary bundling requires significant market power in one market. Most of the economic models analysing exclusionary bundling assume that the dominant firm actually holds a monopoly position in at least one of the markets. While dominance is, rightly, a prerequisite for potential exclusionary concerns, the Commission may signal that it is actually super-dominance that is required when the "strength of the dominant position" is listed as an element of the overall assessment (see paras 188 and 196).

■ **Exclusionary effects from mixed bundling likely to be weaker.** The Discussion Paper defines the various types of bundling strategies (except metering), and implicitly recognises (see para 189) that mixed bundling has less potential for foreclosure effects than tying and pure bundling, a presumption generally consistent with the economic literature. While the claim on tying and pure bundling is not warranted, this statement seems to signal that mixed bundling has less foreclosure potential.

■ **The exclusionary test for mixed bundling.** Recent economic theories of exclusionary bundling investigate the circumstances in which mixed bundling acts as a form of predation, and can therefore exclude competitors of unbundled products. The predation-like test proposed by the Commission investigates whether the supply of the additional product in a bundle is profitable for the dominant firm and is consistent with recent proposals to devise such a test .

The cost-based test suggested by the Commission to assess the exclusionary effect of mixed bundling relies on a comparison of the incremental price of the product (B) added to the bundle with the long-run incremental costs of including that product in the bundle. The cost measure includes all the costs associated with producing B, assuming that A is already produced (where A is the product for which the dominant firm holds significant market power). This test is consistent with the *Ortho Diagnostics Systems Inc v Abbott Laboratories* (1996) test developed in the US.

However, this test has been criticised for potentially condemning bundling void of exclusionary motives (or effects), and alternatives have been proposed – mainly to couple the cost test with other types of evidence (for example, the size of the market being potentially foreclosed). In fact, if the incremental price of the additional product is above its incremental cost of production, there should be a presumption that no exclusionary effect is likely. However, the Commission takes the opposite view: "it may exceptionally be concluded that, although the price exceeds the long-run incremental costs, the mixed bundling nonetheless is considered exclusionary" (para 190).

■ **The reactions of rivals and competition between bundles.** The possible competitive response of rivals and their ability to offer competing bundles is firmly recognised by the Discussion Paper (see para 202). This recognition is to be welcomed (the likely reaction of rivals was an important element in the *Tetra Laval/Sidel* CFI judgment). The Discussion Paper implicitly acknowledges that competition between bundles can be fierce, by advocating a predation test in such circumstances. It is, however, unfortunate that the Discussion Paper does not explicitly recognise the fact that bundle competition can be aggressive and benefit consumers.

Consequently, when competition takes the form of bundle vs bundle, bundling will only be abusive if the price of the entire bundle is predatory (ie the price of the bundle should be

compared with the AAC of producing the bundle, and not the incremental cost of just one component). In effect, when competition is between bundles, the Discussion Paper considers (see para 195) that predation would be the sole potential abuse, independently of the strength of the dominant position on one of the markets. In such circumstances, the mere fact that firms are bundling their offers does not imply that foreclosure effects are more likely.

## The weaknesses

■ **The price discrimination motive for bundling.** The Discussion Paper focuses on "exclusionary effects" arising from bundling but excludes others ("However, tying and bundling can lead to the following possible anticompetitive effects: foreclosure, price discrimination and higher prices": para 179).

The type of bundling strategy that would lead to higher prices is unclear but it is unfortunate that price discrimination is presented as a potential anticompetitive effect of bundling when actually it represents a possible rationale for implementing the strategy. The early economic literature on bundling by a monopolist focused exactly on the attractiveness of bundling to discriminate across buyers, especially in the presence of negatively correlated preferences for the products.

(Preferences are negatively correlated when customers with high valuations for product A tend to have low valuation for product B, and vice versa. For example, customers with high valuations for the image editing Adobe Photoshop software – for instance, photographers – will have low valuations for the statistical package Stata, while statisticians will tend to have high valuations for Stata but low valuations for Adobe Photoshop. )

There are circumstances in which such bundling can actually increase total welfare. The ambiguity of the effect of price discrimination on consumer welfare is well-known in economics. Criticisms of the Commission's approach to price discrimination are recurrent and the tying and bundling section of the Discussion Paper is no exception to the general approach followed by the Commission in relation to price discrimination.

■ **Pricing efficiencies and the Cournot effect.** The fact that pricing efficiencies may arise from bundling (particularly in the case of complementary products) is also ignored by the Discussion Paper. The Cournot effect (the multi-product firm equivalent of the elimination of double marginalization effect in the vertical context) arises when pricing decisions for several complementary products are made by the same entity, and therefore, pricing externalities are internalised. Such pricing efficiencies may arise and should be considered when assessing bundling effects.

■ **The factors that make foreclosure more or less likely.** The Discussion Paper usefully recognises factors that may strengthen or weaken foreclosure: product differentiation, network effects and economies of scale. These factors are indeed relevant for the assessment of exclusionary bundling. However, the role of these market characteristics and their impact on the potential for foreclosure is not fully explained in the Discussion Paper. The Commission indicates that "network effects may allow the dominant company to "tip" the market as the tying can deprive its rivals of the chance to derive network effects through the tied customers" (para 199). In fact, network effects are a crucial element in linking current bundling strategies to future foreclosure effects but in particular circumstances that need to be clearly identified .

Product differentiation arguments (which may actually hurt or benefit rivals) also tend to be relevant in context where the products are not perfect complements.

■ **The nature of the products in the bundle is not taken into account.** Unfortunately, the Discussion Paper does not distinguish foreclosure effects when the bundled products are complements and when they are substitutes (or independent). Indeed, in the economic literature, exclusionary bundling tends to be stronger in the presence of products with strong complementarities. The nature of the theories of harm, the efficiency rationale for engaging in bundling and the relevant market circumstances to assess foreclosure effects can differ quite substantially when the products are complements. A distinct analysis for complements and substitute/independent products would have offered a clearer framework for the analysis of exclusionary bundling.

More generally, the distribution of customer preferences will be crucial in determining the profitability of strategic bundling. When all customers have positive valuations for both products, the likelihood of exclusionary effects may be stronger, even when the products are not complements. While it would be impossible (in practical terms) to identify exactly the distribution of customer preferences in order to assess foreclosure effects, the role of these preferences in strengthening or weakening exclusionary effects should be more specifically recognised. The sole reference to customer valuations can be found in the discussion of product differentiation where the Commission indicates that "customers with strong preferences for the products of competitors in the tied market may, for instance, prefer to switch to a rival product in the tying market rather than forego their preferred product in the tied market" (see para 200).

The lack of a systematic reference to customer preferences may explain the unwarranted observation that "in the case of tying and pure bundling, the individual customers in question clearly are foreclosed to the competitors – at least until the expiry of contracts in the case of contractual tying" (see para 189). More specifically, the definition of tied customers as being those for which rivals "cannot compete" should be further elaborated. Why have customers chosen the dominant firm's product in the first place? Were rivals unable to compete ex-ante? Why are they unable to compete? How many customers actually want both products?

The exclusionary potential of mixed bundling (even if it satisfies the predation-like test) will depend on the customers' valuations for product A (where there is dominance) and B (the competitive market). If the majority of customers have high valuations for A and B, then exclusionary bundling (ie incremental price below long-run incremental cost) could have stronger foreclosing effects on the producers of the unbundled product B. If the products are independent, and most customers of B have low valuations for product A, foreclosure claims could be much weaker (unless, depending on the circumstances, a dynamic foreclosure story may be developed). Customer preferences should be clearly identified as an important factor of the analysis.