Antitrust Law & Economics: Exclusionary Behavior, Bundled Discounts, and Refusals to Deal

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Introduction

- I'll discuss these issues, using two papers submitted on behalf of the United States Telecom Association in response to the Antitrust Modernization Commission's Request for Public Comments.
  - Tim Muris, *Antitrust Law, Economics, and Bundled Discounts.*
  - Doug Melamed, *Comments on Refusals to Deal and the Essential Facilities Doctrine.*

Basic Framework

- An enforcement regime should minimize the sum of error costs and direct costs.
- Error costs include those from condemning or deterring procompetitive conduct (false positives or type I errors), and from allowing anticompetitive conduct (false negatives or type II errors).
- Direct costs include litigation, compliance, and administrative costs.

Error Cost Tradeoff for Exclusionary Behavior Under Section 2

- History of Section 2 enforcement has seen far too many mistakes.
- Notwithstanding a century of litigation, the scope and meaning of exclusionary behavior under the Sherman Act remains poorly defined.
- The costs of type I error are relatively high when antitrust enforcement attacks price discounting or ubiquitously used vertical practices.
- Taken together, these factors suggest a cautious approach to the expansion of Section 2 liability.

Verizon v. Trinko, 540 U.S. 398 (2004) and Refusals to Deal

- The Supreme Court's modern approach to refusals to deal is consistent with a cautious approach to Section 2 liability that minimizes the sum of error costs and direct costs.
- Liability requires that four necessary (but not sufficient) conditions be met:
  - A showing of harm to competition in the market (not harm to competitors).
  - The existence of monopoly power, or a dangerous probability of achieving it.
  - An administrable means to enforce a court-ordered duty to deal.
  - A showing that a refusal to deal makes no economic sense outside of its exclusionary effect.

Section 2 and Refusals to Deal

- No economic sense test should be applied with caution.
- There is no need for a separate essential facilities doctrine.
- Current law appropriately balances error costs and direct costs, and new legislation is not needed.

Brooke Group, 509 U.S. 209 (1993)

- Test for single product price predation illustrates the cautious approach to Section 2 liability of the Supreme Court.
  - Hard to satisfy two-part test requiring proof of below-cost pricing and a showing of a dangerous probability of recoupment reflects high type I error costs (the suppression of price competition).
  - Focus on market realities rather than hypotheticals rejects theoretical possibility of harm as a sufficient basis for liability.
  - Use of bright line test that firms can understand and courts can administer reduces the direct costs of antitrust enforcement.

LePage's v. 3M, 324 F.3d 14 (3rd Cir. 2003) and Bundled Rebates

- The Third Circuit's approach in *LePage's* failed to exercise caution in applying Section 2 to bundled rebates.
- The decision rests on a poorly articulated theory of economic harm, and on an incomplete record.
- Under *LePage's*, showing that bundled rebates by a dominant firm "may foreclose portions of the market to a potential competitor who does not manufacture an equally diverse group of products and who therefore cannot make a comparable offer" was a sufficient basis for Section 2 liability.
- The decision allows a jury to find a dominant firm liable under Section 2 based on the *possibility* that bundled rebates, including those that increase consumer welfare, could exclude an allegedly equally efficient competitor.
- Thus, the decision focused on hypotheticals and not on market realities.

Bundled Discounts and the Cost of Type I Error Under *LePage's*

- Bundled discounts are ubiquitous, are used for many reasons, and are observed in markets both with many sellers and with few sellers. Widespread use of bundled discounts in competitive markets suggests a presumptive explanation that bundling is efficiency based. These efficiency explanations apply with equal force to bundling by firms with market power.
- Bundled discounts are used to give selective discounts to end users, and are used as an alternative to traditional advertising, or as a way to promote new products or services.
- Bundling can reduce transactions costs on both the purchasing and selling side of the market.
- Firms also use bundled discounts at wholesale to give retailers strong incentives to promote and sell their products and services. They can serve the same efficiency promoting vertical control functions as has been identified in the literature examining tying, exclusive dealing, and other vertical restraints.
- LePage's standard-free approach to Section 2 liability applied to a ubiquitously used and presumptively efficient practice will likely impose high error costs from false positives.

Consumers of Telecom Products and Services Demand Bundles

- Multiple consumer surveys show a significant percentage of residential and business customers desire multiple communications services, including voice, video, and data, from a single provider.
- Some surveys show that over half of survey respondents were "interested in purchasing all of their telecommunications services from one provider."

Reasons That Consumers Prefer Telecom Bundles

- Reasons consumers demand bundles include:
  - The convenience of one-stop shopping (reduced transaction and information costs).
  - Simplified billing.
  - Lower prices, higher value associated with the bundle.
  - Integration of products and services.

Economic Literature on Exclusionary Bundling

- Economic models show that bundling can be used to exclude competitors.
- These models show that anticompetitive harm is possible; they fall far short of showing that such harm is likely.
  - These models contain many restrictive assumptions, including the assumption that a firm has an actual monopoly.
  - They do not consider efficiencies from bundling or other alternative explanations for the practices.
  - The models and the assumptions have not been tested for robustness or their empirical application to the real world.
- As a result, these models do not allow us to gauge whether the potential for anticompetitive harm outweighs the demonstrable benefits from bundling.

Exclusion of Equally Efficient Competitor

- Some economic and antitrust analyses have focused on bundling as a way to exclude an equally efficient competitor (EEC).
- However, such a focus is misguided for several reasons:
  - Use of EEC standard inappropriately focuses inquiry on harm to competitors rather than harm to competition.
  - Bundled discounts that would exclude a hypothetical EEC can lower prices and increase consumer welfare.
  - All else being equal, how can a firm that offers you less of what you want be equally efficient with a firm that offers you more?

Example from Hovenkamp (2005)

- Multiproduct firm makes products A and B, which have costs of $12 and $7, respectively.
- No bundling prices are $14 and $8 respectively.
- Bundle price is $20 (a $2 discount off the stand-alone prices).
- However, such a discount would force a B-only competitor to price its goods below cost (at $6) if it wanted to take sales away from the multiproduct firm.
- Thus, this bundle discount is "exclusionary" under EEC test, because it would exclude an equally efficient competitor.
- Yet, in the example, the bundle price lowers the price to consumers, and would immediately increase consumer welfare.

Experimental Tests of Bundling Theories

- Economists at the Interdisciplinary Center for Economic Sciences at George Mason University (ICES), including Vernon Smith, recipient of the 2002 Nobel Prize in Economics, have begun to test economic models of bundling.

An Overview of Experimental Economics

- Experimental economics uses laboratory subjects to test the validity of various economic theories and the effect of market and regulatory institutions.
- Economic experiments use cash incentives to understand better how firms and markets work.

Experimental Evaluation of Anticompetitive Bundling Theories by ICES

- Baseline experiment has a monopolist in the A market who also can sell in the B market.
- The B market also can be served by up to three B-only sellers.
- Goods are sold by posted offer.
- Experiments are dynamic, and sales occur over multiple (>150) periods.
- Entry is costly.
- Baseline treatments involve cases in which bundling by the A monopolist is (1) prohibited, and (2) permitted.
- The experiments include cases in which the prediction in the theoretical literature is that bundling will lower welfare.
- Variations from the baseline case include changes in the correlation of reservation values, the existence of efficiencies from bundling, and introducing a fringe competitor to the A monopolist.

Baseline Results

- Experimental evaluations of bundling finds that bundled discounts by a monopolist in the A market can exclude competitors selling in a second B market.
- However, the experiments generally find that consumer welfare increases in both the short- and long-run when bundling is used.
- Finding cases where bundling does not increase welfare requires extreme assumptions regarding the nature of demand in the B market.
- Specifically, lowering welfare requires that, for a significant number of consumers, their reservation value for the B good (or the maximum amount a buyer is willing to pay for B) greatly exceeds their reservation value for the A good, so that B sales are highly attractive relative to A sales.

Additional Results

- Variations to the baseline include considering efficiencies from bundling: buyers incur transactions costs each time they make a purchase, and purchasing the bundle lowers these transactions costs.
- Other variations include the introduction of a fringe firm in the A market. The capacity of the fringe firm is a small fraction of the capacity of the former A monopolist.
- When either efficiencies are considered or the assumption of monopoly in the A market is relaxed, the welfare increasing effect of bundling increases.

Potential Exclusionary Bundling Standards

- Test based on the exclusion of a hypothetically equally efficient competitor.
  - It wrongly assumes competitor is equally efficient based solely on the costs of production. Moreover, the test is overinclusive and would condemn welfare increasing bundled discounts.
- Test for *de-facto* tying [Greenlee, et al. (2004)]. This test potentially separates welfare increasing and welfare decreasing bundled discounts, and requires that the price of the monopoly good be raised above the monopoly price in the absence of bundling.
  - Test requires knowledge of the hypothetical monopoly price in the absence of bundling. In many cases, such a price will not be easily observable, which increases the direct costs associated with using such a test.
  - Consideration of alternative reasons for bundling would further complicate use of this test.
  - Based on preliminary experimental results, conditions under which de-facto tying will emerge are limited.
- Modified *Brooke Group* Test based on the bundle price exceeding the cost of the bundle.
  - While rejected by the Third Circuit, such a test would have the advantage of being administrable, and such a bright line test would minimize direct costs and the costs of false positives.
  - Such a test is appropriate given the absence of evidence that the cost of false negatives from anticompetitive exclusionary bundling is large.

Conclusion

- Application of Section 2 to exclusionary conduct requires a cautious approach to minimize the sum of error costs and direct costs.
- The federal courts have likely reached an appropriate balance when addressing refusals to deal.
- This is not true for bundled discounts. The Third Circuit's decision in *LePage's* is standard free, and this standard-free approach has spread beyond the Third Circuit.
- The government's position in *3M v. LePage's*, as well as the Court's decision not to take the case, was sensible given the incomplete nature of the record and the Third Circuit's poorly articulated theory of economic harm. However, this Commission could provide beneficial guidance via policy statements or guidelines. Such guidance would reduce the probability that the Third Circuit's flawed approach would be applied generally, and would help reduce the uncertainty this decision has created.