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Competition Competence Report

TYING AND BUNDLING: THE NEW EC NON-HORIZONTAL MERGER GUIDELINES

The European Commission is about to develop guidelines for vertical and conglomerate mergers. On behalf of the European Commission, Professor Church performed an extensive literature review on the impact of vertical and conglomerate mergers on competition, the so-called "Church-Report".[1] The "Church-Report" provides a detailed survey on economic models and findings. However, the report sticks very much to the theory and offers little guidance for both, practitioners and the European Commission how to apply the theory to specific cases. This CCR intends to close this gap with a special focus on potential competitive harm through bundling and tying. Firstly, it is demonstrated that the specific theoretical models give only poor guidance as the results are often contradictory depending on the assumptions made. Secondly, the CCR identifies the most important insights of the economic literature that are applicable in practice and should be included into the European Commission's guidelines. The next CCR will cover the other aspects of the Church Report: portfolio effects, input and customer foreclosure.

Economic Theory on Tying and Bundling

Economic theory on tying and bundling changed over the years. Historically, liberal scholars like *Bork* and *Posner* claimed that tying and bundling could hardly have any anti-competitive effects at all: tying and bundling is typically beneficial or associated with price discrimination.[2] This thinking is based i.a. on the so called "single profit theorem". According to this

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1 Church, Jeffrey, „The Impact of Vertical and Conglomerate Mergers on Competition", Brussels 2004; in: http://europa.eu.int/comm/competition/mergers/others/#study

2 Bork, Robert , The Antitrust Paradox, 1978; Posner, Richard, Antitrust Law, 1976.

theory, there is only one monopoly profit. Therefore a monopolist cannot increase his profits by leveraging his monopoly power into a competitive downstream market. In general, the problem of the single profit theorem is that the model is not robust if assumptions are changed. For example, if fix costs are introduced bundling may be a profit-maximizing strategy for the monopolist.[3] According to *Nalebuff*, monopoly leveraging might also be profitable, if the assumption is relaxed that goods are consumed in fixed proportions. On the other hand critique on the single profit theorem applied to complements holds that - when consumers are homogenous - a monopoly supplier of one complement can extract all of the monopoly profit through the price of his product and he need not to monopolize competitively supplied complements by tying or bundling. Thus, relaxing assumptions changes the single profit result and may provide in some cases an incentive for vertical or conglomerate integration based on market power.

Today, economic theory offers a more thorough picture of possible incentives and effects of tying and bundling. It is well understood that tying and bundling can serve many purposes, both pro-competitive and anti-competitive. There are possible efficiency-enhancing effects of bundling including cost saving, improvement of quality, and reduction of pricing inefficiencies. Also, bundling and tying is often used as a price discrimination device. Possible anti-competitive effects of bundling can be the creation of entry barriers, foreclosure effects or the exclusion of competitors.

Models as Practical Guidance ?

In principle, economic models are not really functional for practical analyses in merger cases. Either the welfare effects are ambiguous, or the results halt – like "the single profit theorem" – because of specific assumptions. Some of the theories are not robust at all. For example, a critical issue is the mode of competition applied in the respective model. *Carbajo et al*. show that in the case of Bertrand competition tying can serve as a mean to differentiate products and reduce competition between rival firms leading to higher prices and higher profits.[4] Introducing Cournot competition into the same framework leads to a totally different result. The monopolist sets the prices of his products more aggressively. The results are lower prices, lower profits for the competitor and a vague result for the monopolist's profits. Since there is no general rule which

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3 Whinston, Michael, The American Economic Review 80 (1990), p. 837-859.

4 Carbajo, José et al., Journal of Industrial Economics 38 (1990), p. 283-298.

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E-Mail: DHildebrand@ee-mc.com*Homepage: http://www.ee-mc.com

mode of competition describes markets adequately, only limited practical conclusions can be drawn from the different theoretical models.

Another critical issue is that most of the theoretical models assume a monopolistic market structure in at least one of the markets. In theory, tying or bundling a monopoly product reduces the demand for the competitor's single product. It may force the competitor to enter the market on two stages or it may create other competitive disadvantages. As pure monopolies hardly ever exist in reality, the practical relevance of these discussions is uncertain.

Another discussion is that anti-competitive effects are created by the unequal competition between a firm that produces a bundle and a single product firm. However, in an oligopolistic market there is the possibility that non-integrated competitors co-operate and sell competing bundles too. According to *Nalebuff*, competition in bundles may have strong pro-competitive effects as it might lead to lower prices and increased consumer welfare.[5]

These few examples illustrate already, that the models described in the "Church Report" can only serve as a framework proving the existence of certain possible economic effects. They provide little guidance for practical analyses in merger cases. It is therefore open to discussion whether detailed vertical & conglomerate merger guidelines ("guidelines") can be drawn from these findings as the results depend on theoretical assumptions and are often contradictory.

Requirements for the European Commission's Non-Horizontal Merger Guidelines

If the European Commission publishes guidelines, the aim is that they should be clear and focused on undisputable findings. In addition, guidelines should not be based on specific theoretical models. They should instead elaborate on general insights that have been gained on bundling and tying over the years. One main finding is that the effects of bundling depend predominantly on the characteristics of the relevant market. Thus, the guidelines could provide detailed instructions how to perform analyses. In the following, this CCR proposes certain conclusions that can be drawn from the current economic literature <u>and</u> are applicable to real cases.

5 Nalebuff, Barry Working Paper Series H #7, 2000, available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=239684.

List of Proposed Criteria

- <u>Market position in the tying market</u>

  If the tying market is competitive, the product tie cannot force consumers to buy the tied good as they can easily switch to competing products that are offered without a tie. Therefore, a necessary but not sufficient condition for competitive harm is market power in the tying market. The higher the market power the easier is it for the tying firm to impose the tie on its customers.

- <u>Market position in the tied market</u>

  Monopoly leveraging can arise, even if the market position in the tied market is a very weak one since a tying-strategy can lever market power on this "weaker" market. However, tying two products also bears the risk for the tying firm to loose those customers who don't find the tied product very attractive and want to avoid it. This risk is higher if a firm ties an unattractive product with low market share. Monopoly power can be leveraged more easily on a market if the tied good already enjoys high popularity and remarkable market shares.

- <u>Entry barriers</u>

  It should be considered if bundling and tying force new competitors to enter several markets at the same time and, thus, raise market entry barriers and lower potential competition.

- <u>Complementarity of the products</u>

  Another factor that has to be taken into account when assessing the potential harm of bundling is the complementarity of the included products. Only if consumers usually consume the tied or bundled goods together, a bundle or tie can have a significant anti-competitive effect.

- <u>Feasibility of counterstrategies</u>

  In a merger analysis, the European Commission should always assess the feasibility of counterstrategies. Competitors might form

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competing bundles leading to lower consumer prices. Also, strong buyer power can prevent leveraging or foreclosure effects. Special attention should be paid to the effect of bundling on prices and market share of competitors.

- Variety bundles

  This kind of bundle provides consumers with a greater variety of products with no or only a small increase in price, e.g. software bundles, bundled pay-TV offers or combined tickets for skiing areas, theme parks, museums etc. Generally, these bundles have pro-competitive effects as they create a wider product variety for almost no extra cost enhancing consumer welfare. Anti-competitive effects can only arise, if the attractiveness of this bundle is so outstanding that the other market participants are not able to form competing bundles and are consequently foreclosed. However, the analysis of potential anti-competitive effects has to be a thorough one as false convictions prevent potential positive effects.

- Efficiency effects

  The guidelines should take into account possible efficiency-enhancing effects of an alleged bundling. Cost reductions, quality improvements or efficient pricing might offset suspected anticompetitive effects.

- Allow commitment of the companies

  If the European Commission fears that tying or bundling might harm competition, companies should be given the possibility to commit not to bundle or tie post-merger. If the market is transparent, the European Commission can easily supervise such commitments enabling firms to realize merger-specific efficiencies and to reduce at the same time possible anti-competitive effects.

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