

**GCP**

THE ONLINE MAGAZINE FOR GLOBAL COMPETITION POLICY

# Some Thoughts on Bundled Rebates and Exclusionary Policies

---

H.E. Frech III

University of California, Santa Barbara

## **Some Thoughts on Bundled Rebates and Exclusionary Policies**

H.E. Frech III \*

**B**undling and related exclusionary practices are both common in the economy and often challenged under the antitrust laws. The following remarks highlight a few issues. This is not a complete discussion of these issues, let alone a complete treatise on the economics of bundling.

### **I. BUNDLING PRACTICES THAT RAISE ANTITRUST CONCERNS RARELY INVOLVE SALES TO FINAL CONSUMERS**

It is commonly observed that bundling products or services is pervasive in the economy. Examples cited include automobile dealerships bundling cars with tires, McDonald's Happy Meals bundling hamburgers, fries, soda, and a toy, and theaters bundling individual performances into season tickets.<sup>1</sup> While it is certainly true that

---

\* The author is a Professor of Economics at the University of California, Santa Barbara. He has also worked as a consultant, often through LECG, on a number of antitrust cases involving allegations of bundling, including *Litton Systems, Inc. v. Honeywell, Inc.* (1996 U.S. Dist. LEXIS 14662) and *Retractable Technologies, Inc. v. Becton Dickinson & Company* (see Mary Williams Walsh & Walt Bogdanich, *Syringe Manufacturer Settles Claim of Market Manipulation*, N.Y. TIMES (Jul. 3, 2004)). This article is based on remarks made at a panel on bundled rebates, at the Newport Summit on Antitrust Law and Economics, Newport, Rhode Island, May 31, 2008. Thanks are due to the other members of the panel, Ben Klein in particular, and the audience for helpful and lively discussion. Thanks are also due to Mike Smith of the Century City, California office of LECG for help in preparing this article.

<sup>1</sup> For discussions of the pervasiveness of bundling, see Robert E. McCormick, William F. Shughart II & Robert D. Tollison, *A Theory of Commodity Bundling in Final Product Markets: Professor Hirshleifer meets Professor Becker*, 26 INT'L REV. L. & ECON. 162 (2006) and Stefan Stremersch & Gerald J. Tellis, *Strategic Bundling of Products and Prices: A New Synthesis for Marketing*, 66 J. MARKETING 55 (2002).

bundling products or services in sales to final consumers is a common practice, this statement is misleading in an antitrust context. It is misleading because antitrust concerns arise when bundling has the possibility of harming competition by impeding access to downstream distributors and such a possibility is not created when bundling occurs only in sales to final consumers.<sup>2</sup> The possible harm is created at least one level up the vertical supply chain above final consumers. In fact, bundling to final consumers is often a form of price discrimination, as was long ago described by George Stigler, or simply a saving in consumer effort. This type of consumer-oriented bundling would not normally raise antitrust concerns.

## **II. THE MAIN UNDERLYING ECONOMIC ISSUE IS EXCLUSIVE DEALING— BROADLY CONSTRUED**

Since the main antitrust concern with bundling practices is the possible limitation of access for rivals to distribution channels, a focus solely on bundling practices is too narrow. The fundamental economic issue is exclusive dealing, more broadly defined. Bundling is simply one of many practices that sellers may use to pay for and achieve a degree of exclusivity at a downstream level. Furthermore, as will be discussed again below in a different context, these various practices often occur together. The goal is some degree of exclusivity and bundling is one way to pay for it. Therefore, it is useful to broaden our focus on practices employed. Often, exclusionary practices include, but are not limited to, bundling, loyalty discounts, and explicit exclusive dealing.

---

<sup>2</sup> The question of which participant performs the role of the distributor in this sense can be subtle and depend on context. For example, in health care, the role of distributor is for some purposes performed by hospitals, for some purposes performed by a health plan, and for some purposes performed by a group purchasing organization (GPO).

## **A. Bundling**

Bundling occurs when sellers offer a discount or rebate to buyers for accepting a bundle of separate goods. For example, a hospital may offer a lower price to a health plan if the health plan agrees to purchase all services from the hospital rather than purchasing services separately. Here, the health plan plays the role of the distributor for the hospital services. While firms selling the bundle will typically use discounts to create the incentive to purchase the bundle rather than separate products or services, firms can use stronger incentives, such as prohibiting the purchase of products separately. That is, a seller may only offer the bundle. For sound economic reasons, an absolute requirement to accept the bundle is not so common.

## **B. Loyalty Discounts**

Loyalty discounts occur when a seller offers a lower price if the distributor agrees to take a high percentage of its purchases in a particular product category from the seller. For example, a seller of syringes might offer a hospital a 30 percent discount if the hospital agrees to buy at least 80 percent of a certain type of syringes from the seller. Often multiple loyalty discount tiers are offered by a seller. For example, the syringe seller may also offer a 40 percent discount if a hospital agrees to purchase at least 90 percent of its syringe requirements from the seller. Loyalty discounts are sometimes called “market share discounts.”<sup>3</sup> By using loyalty discounts, the seller, in effect, pays the distributor for a degree of exclusivity.

---

<sup>3</sup> Note that this is an instance of commercial firms using a concept of market definition that is similar to the one used by economists in antitrust. Antitrust market definition puts arbitrary boundaries on the natural continuum of substitution in order to simplify analysis. The use of a similar concept in loyalty

It is not uncommon for sellers to combine the practices of offering loyalty discounts and bundling. In some contexts, bundling would be virtually toothless if it were not so combined. Suppose the seller of syringes wanted to bundle two types of syringes. If there were no loyalty discounts, a hospital could agree to accept the bundle purely formalistically by purchasing a tiny amount of one type. To combat this, the seller will often combine the bundle with loyalty discounts by, say, offering discounts on two goods conditional on meeting or exceeding certain market share loyalty targets in *both* goods.<sup>4</sup> The pricing can become Byzantine. There can be discount tiers, some based on single-product market share levels and some based on the bundle. Continuing the syringe example, for each product type separately there could be a discount of 20 percent off the list price for a minimum 80 percent market share commitment. Then there could be an additional 10 percent discount for a minimum 80 percent market share commitment in *both* product types. Often the share targets and discounts differ for the different products and the bundle can include many products, related or not. The common thread is that the seller is rewarding the distributor for some degree of exclusivity.

### **C. Explicit Exclusive Dealing**

Bundling is often combined with various types of explicit exclusive dealing. The bundle may include goods that are explicitly subject to exclusive dealing. The discount on the exclusive good, or the other goods, may be conditional on accepting the entire bundle. Also, there can be two effective levels of distribution, such as in the sale of

---

discounts shows that this is not purely a legal abstraction. But, even though the principle is the same, these market-driven definitions may be larger or smaller than the ones used in antitrust.

<sup>4</sup> While the term seems to have fallen out of common usage, this can also be called “full-line forcing”.

medical supplies and devices to hospitals. There is the group purchasing organization (GPO), which contracts with the supplier and the hospital, to facilitate the relationship. There is also the hospital, which, after combining with other inputs, resells the supplies to the final consumer of health care. In the GPO relationships, it is common for sellers of devices and supplies to have explicit exclusive dealing with the GPO (typically called sole-source agreements) and then to extend both bundling and loyalty discounts to the hospitals themselves.

### **III. EXCLUSIVE DEALING PRACTICES CAN HAVE PRO-COMPETITIVE, ANTICOMPETITIVE, OR NEUTRAL EFFECTS**

Understanding that bundling and loyalty discounts can be viewed as methods of exclusive dealing does not imply that they should necessarily be condemned. As the economic literature clearly shows, exclusive dealing practices may have pro-competitive, anticompetitive or competitively neutral effects. The pro-competitive effects generally come from two sources: inducing efficient dealer services and combing demanders to present a more elastic demand curve to the seller.<sup>5</sup> The anticompetitive effects of exclusive dealing are simpler to analyze. They arise from excluding or marginalizing rivals or raising rivals' costs.<sup>6</sup>

---

<sup>5</sup> On improving incentives for dealer services, see Howard P. Marvel, *Exclusive Dealing*, 25 J.L. & ECON. 1 (1982); Benjamin Klein & Andres V. Lerner, *The Expanded Economics of Free-Riding: How Exclusive Dealing Prevents Free-Riding and Creates Undivided Loyalty*, 74 ANTITRUST L.J. 473 (2007). On combining demanders to increase price competition, see Benjamin Klein & Kevin M. Murphy, *Exclusive Dealing Intensifies Competition for Distribution*, 75 ANTITRUST L.J. (forthcoming 2008).

<sup>6</sup> See Eric B. Rasmusen & J. Mark Ramseyer, *Naked Exclusion*, 81 AM. ECON. REV. 1137 (1999) and William S. Comanor & H.E. Frech III, *The Competitive Effects of Vertical Agreements*, 75 AM. ECON. REV. 539 (June 1985).

Of course, the anticompetitive harm is more likely if the firm employing the exclusionary practices has market power. In this connection, it is best to remember that market power includes the ability to raise price or the ability to exclude competitors. These can be quite different.<sup>7</sup> Anticompetitive effects are also more likely if the industry is subject to scale economies and learning by doing.

#### **IV. THE ANTITRUST MODERNIZATION COMMISSION'S THREE-PRONGED TEST**

The U.S. Antitrust Modernization Commission has proposed a three-pronged test for anticompetitive bundling:<sup>8</sup>

1. price-cost comparison: attributing all discounts to the product at issue, plaintiffs must show that the price is below incremental costs;
2. recoupment: the plaintiffs must show that the defendant is likely to recoup the losses from its below-cost pricing; and
3. competitive harm: the plaintiff must show actual or probable harm to competition.

The first two prongs are intended to screen out weak cases without spending the resources necessary for a full rule-of-reason investigation. The third prong amounts to the rule-of-reason test. The first two prongs would follow from treating bundling as if it were predatory. I do not think that this is a productive way to view bundling, in part because bundling and other exclusionary practices do not ordinarily have a dynamic aspect. That is, there is no profit sacrifice that must be recouped—the practice itself is profit-

---

<sup>7</sup> See Thomas G. Krattenmaker, Robert H. Lande & Steven C. Salop, *Monopoly Power and Market Power in Antitrust Law*, 76 GEORGETOWN L.J. 41 (1987).

<sup>8</sup> ANTITRUST MODERNIZATION COMMISSION, REPORT AND RECOMMENDATION 83 (2007). For an excellent commentary, see Jonathan Jacobson, *Exploring the Antitrust Modernization Commission's Proposed Test for Bundled Pricing*, 21 ANTITRUST 23 (2007).

maximizing. This has been described as “simultaneous recoupment,” which strikes me as a confusing and unnecessary concept. Further, there are considerations, discussed in the next section, that make prongs **1** and **2** less workable and not offer much of an advantage over a full rule-of-reason analysis. So, I am not fond of prongs **1** and **2**. Still, it is worth noting that in a couple of the cases I have worked on (*Litton v. Honeywell* and *RTI v. Becton Dickenson*), it was easy to make a preliminary showing that prongs **1** and **2** were met, at least for many relationships.<sup>9</sup> Prongs **1** and **2** may not screen out many cases after all.

## **V. EXCLUSIONARY PRACTICES OFTEN HAVE A CUMULATIVE EFFECT**

As discussed in the preceding sections, exclusionary practices are often used in concert. Therefore, any test or screen focused on bundling, or any individual practice, analyzed in isolation is inappropriate. The cumulative effect of all the practices, considered in the full economic context, needs to be examined. To analyze the practices one by one makes no economic sense—in effect the individual practices cannot be unbundled. It is as if one examined a masonry dam stone by stone and concluded that since there was no individual stone that could hold back the water, that the dam must not be able to hold back the water, and, therefore, there must not be a lake!

## **VI. THE “EQUALLY EFFICIENT RIVAL” IDEA IS TRICKY IN PRACTICE**

One justification for the price-cost comparison prong is to assert that the bundle must exclude an equally efficient single-product rival. This is often a tricky analysis. For instance, it must be considered that less-efficient rivals can exert important discipline on

---

<sup>9</sup> *Litton Systems, Inc. v. Honeywell, Inc.* (1996 U.S. Dist. LEXIS 14662) and *Retractable Technologies, Inc. v. Becton Dickinson & Company* (see Mary Williams Walsh & Walt Bogdanich, *Syringe Manufacturer Settles Claim of Market Manipulation*, N.Y. TIMES (Jul. 3, 2004)).



the market. Further, with heterogeneous consumers, rivals may be equally efficient for some consumers but not for others, which can be hard to prove one way or the other.<sup>10</sup> Perhaps more importantly, the relative inefficiency at a point in time (e.g., the time of filing the suit) may be a result of past exclusionary activities. The rival may have been deprived of economies of scale and scope, benefits of learning by doing or its research and development or long-term marketing investment may have been discouraged. This may require a broad inquiry going far beyond incremental production costs.

## **VII. DISTINGUISHING PRO-COMPETITIVE FROM ANTICOMPETITIVE EXCLUSIVE DEALING IS DIFFICULT**

All exclusionary practices are voluntarily agreed to by buyers. Indeed, the impetus may have come from some of the buyers. This is true whether the practices have anticompetitive, pro-competitive, or neutral effects. In principle, a group of all buyers would oppose anticompetitive exclusionary practices. However, buyers are often diffuse and smaller, less-organized buyers are unlikely to have the sophisticated knowledge to form an opinion on the matter.

In the context of bundling and loyalty discounts, the price is below a list or separate price. The resulting discounted price, however, may be above or below the competitive price or the price that would have prevailed in a market without the exclusionary practice. Observing discounts and buyer behavior cannot distinguish between pro-competitive and anticompetitive exclusionary practices.

---

<sup>10</sup> See Comanor & Frech (1985), *supra* note 6.

On the other hand, seller behavior can possibly distinguish between the two cases. Sellers, as a group or as dominant sellers, would favor anticompetitive exclusive dealing and oppose pro-competitive exclusive dealing. Of course, in any particular matter, it may be difficult to pin this down.

### **VIII. CONCLUSION**

The bundling practices that potentially raise antitrust concerns seek partial or total exclusivity in distribution. Thus, bundling is best viewed as a type of exclusive dealing along with loyalty discounts and explicit exclusive dealing. Bundling and loyalty discounts by themselves can ordinarily achieve the exact same economic outcome as explicit exclusive dealing. Further, these exclusionary practices are commonly used together so it is normally more useful to view all these exclusionary practices as exclusive dealing, broadly considered. Exclusive dealing can result in pro-competitive, anticompetitive, or neutral effects. The Antitrust Modernization Commission has tried to create a screen to eliminate weak cases without spending a great deal of legal resources. For the reasons stated in this paper, I do not think this effort was successful. Further, the pervasiveness of bundling to final consumers, the existence of discounts off list prices, and the voluntary nature of buyers' agreement do not demonstrate that bundling is pro-competitive or in the interests of all buyers as a group.