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STANDARDS FOR ASSESSING BUNDLED DISCOUNTS

Vandy M Howell, Celeste Saravia
Cornerstone Research

Since the US Third Circuit Court’s LePage’s decision in 2003,1 antitrust attorneys and economists have increasingly debated the appropriate liability test for distinguishing anti-competitive bundled discounts from pro-competitive bundled discounts. This debate was further fuelled by a 2007 report by the US Antitrust Modernization Committee (AMC),2 which recommended an alternative test, and the Ninth Circuit Court’s PeaceHealth3 decision, which partly adopted and partly rejected the AMC’s recommended test. This article describes the economics behind bundled discounts, the criteria that are necessary to distinguish pro-competitive bundled discounts from anti-competitive bundled discounts, and the reasons that the tests adopted by the appellate courts and recommended by the AMC fail to do so.

What are bundled discounts and why do firms offer them?

Bundled pricing or bundled discounting occurs when a multi-product firm offers to sell a bundle of distinct products for a price lower than the combined cost of purchasing all of the products in the bundle separately. This type of pricing and discounting is common across industries and levels of commerce. Bundled discounts are price discounts, which generally are a healthy form of competition. There are a number of pro-competitive or competitive-neutral reasons that firms offer bundled discounts as opposed to simply offering single product discounts.

A firm may realise cost savings by selling bundles of products that could not be realised from single product sales. For example, by selling bundles of products to retailers a manufacturer may realise economies of scope in distribution and contracting. These savings can be passed on to consumers as bundled discounts.

A firm may also offer bundled discounts because its customers demand them. For example, some consumers may demand value meals that include a sandwich, soft drink and french fries. In addition, customers who hold market power in buying - such as large chain retailers - may demand bundled discounts from manufacturers as a way to receive quantity discounts across multiple products.

While bundled discounts are price discounts, they have a special nature due to the fact that they are discounts that rely on the purchase of at least two different products. This allows a firm with market power to use bundled discounts to price discriminate.4 For example, suppose there are two types of consumers. The first type is willing to pay $10 for product A and does not demand product B, while the second type is willing to pay $8 for product A and also demands B, which is available competitively for $4. In this case a monopolist in product A could offer a bundle of A and B for $12 and then the monopoly product on an à la carte basis for $10. This pricing strategy allows the monopolist in product A to extract all the willingness to pay from each type of consumer. Price discrimination in itself has an ambiguous impact on overall consumer welfare. It can also have different effects on different consumers at a given point in time.5

The impact of price discrimination on consumers has not been the focus of the current economic and legal debate that attempts to define when bundled discounts can cause harm to competition and consumers. Rather the focus has been on the potential for bundled discounts to lead to the exclusion of competitors and the leveraging of monopoly power in one market to additional markets. We document below the struggle to identify a clear standard for assessing the competitiveness of any given bundled discount programme.

When could bundled discounts be anti-competitive?

There are academic papers that propose models in which, under certain restrictive circumstances, bundled discounts could be used to exclude competitors. In the simplest model of exclusionary bundling, firm 1 sells both the monopoly product A and a second product B...
that is competitively supplied by firm 1 and other firms at a price of \( PB \), where \( PB \) is equal to the marginal cost of producing \( B \). In this model all consumers who demand \( A \) also demand \( B \). The monopolist offers consumers the choice of either purchasing the monopoly good separately at the monopoly price, \( PM \), or purchasing both \( A \) and \( B \) at the bundled price of \( P_{AB} \), where \( P_{AB} < PM + PB \). When deciding whether to purchase the bundle, consumers compare the price of the bundle to the cost of purchasing product \( A \) at the monopoly price and product \( B \) at the competitive price. Consumers will reject the bundle if they can buy product \( B \) for less than \( P_{AB} - PM \). Because the competitive firms were already pricing at marginal cost and \( PB > P_{AB} - PM \), in this example, no firm can offer product \( B \) for a price at which consumers would reject the bundle. Thus, in this simple model in which all consumers demand both products \( A \) and \( B \), all consumers will purchase the bundle - implying that only firm 1 will make sales of product \( B \).

This model shows how, in a particular circumstance, a multi-product firm with monopoly power in one market could exclude rivals from a competitive market. But, importantly, it does not show why the firm would choose to do so, nor does it demonstrate any harm to consumers. In the stylised example above, if all consumers purchased product \( A \) at the monopoly price, then firm 1 earns lower overall profits when bundling. This is because if the firm did not bundle, it would make monopoly profits on product \( A \) and no profits on product \( B \), but when it bundles it makes \( P_{AB} \) and \( P_{AB} < PM + PB \). Since \( PB \) is the cost of producing product \( B \), firm 1’s profits are lower than the monopoly profits it would earn absent the bundle. For this to enhance the firm's monopoly power and be a profitable strategy (and, related, to cause harm to consumers), it must be the case that the firm expects to make higher profits in the future by raising the price of product \( B \). This is recoupment. But firm 1 will only be able to raise the implicit price of product \( B \) in the future if the competing firms that had been supplying it are unable to re-enter the market.

**Appropriate guidelines for a liability test**

Unilateral conduct can only be anti-competitive if it excludes a rival and as a result, harms consumers. Because bundled discounts are price discounts, the conceptual underpinning behind the predatory pricing standard outlined in Brooke Group offers guidance on when a bundled discount would be anti-competitive. Specifically, there are two important concepts reflected in the Brooke Group test, both of which should be reflected in any bundling liability test if it is to sufficiently protect (not deter) pro-competitive conduct. First, Brooke Group recognises that lower prices are a form of competition and thus any price decrease will be considered safe unless the price cut is so great that it results in prices ‘below an appropriate measure of cost’. In the context of predation, ‘an appropriate measure of cost’ has generally been assessed as a price below the incremental cost of producing the product. The court adopted this standard because it recognised that above-cost price discounts that exclude less efficient rivals represent ‘competition on the merits’ and that a judicial tribunal could not discourage exclusionary above-cost price cuts ‘without courting intolerable risks of chilling legitimate price-cutting’.

Second, even if a price is below cost, Brooke Group would not find a firm liable unless there was a reasonable possibility that the firm would be able to recoup the profits lost through the price cut. This is because ‘without [recoupment], predatory pricing produces lower aggregate prices in the market, and consumer welfare is enhanced’, implying that ‘unsuccessful predation is in general a boon to consumers’. Thus, the first prong of the Brooke Group test guarantees that prices will not be deemed anti-competitive unless they are so low that an equally efficient rival would be excluded from profitably competing in the market. The second prong requires that there be a reasonable possibility that consumers will be harmed by the loss of competitors. It is this complete logic that should be applied to any proposed test of bundled discounts.

**Review of tests**

**LePage’s**

The Third Circuit Court’s LePage’s decision has received a great deal of attention for assessing bundled discounts in the context of general non-price exclusionary conduct. In that case, LePage’s, a manufacturer of generic translucent tape, alleged that 3M used its monopoly in Scotch tape to gain a competitive advantage in the private label tape portion of the transparent tape market through the use of multi-tiered bundled rebates and other actions, including exclusive contracts with some retailers. The jury found for LePage’s, and 3M appealed the verdict. The Appellate Court concluded that 3M’s bundled rebates ‘could reasonably have been viewed as effectuating exclusive dealing arrangements because of the way in which they were structured’ and that ‘when offered by a monopolist [bundled
rebates] 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'.

The LePage’s decision has been widely criticised for not appropriately distinguishing between pro-competitive and anti-competitive bundled discounts. By adopting a liability test that hinges on whether a competitor ‘manufacture[s] an equally diverse group of products’, the LePage’s decision failed to consider whether a competitor was in fact excluded and more importantly whether consumers were harmed by that exclusion. For example, a multi-product firm may simply be more competitive than a single product firm if the multi-product firm experiences efficiencies in producing and selling multiple products together.

PeaceHealth

A number of years after LePage’s, the Ninth Circuit Court decision in PeaceHealth rejected the Third Circuit Court’s logic. In its PeaceHealth decision, the Ninth Circuit Court adopted the following price-cost standard based on the price-cost test outlined in Brooke Group:

To prove that a bundled discount was exclusionary or predatory for the purposes of a monopolisation or attempted monopolisation claim under section 2 of the Sherman Act, the plaintiff must establish that, after allocating the discount given by the defendant on the entire bundle of products to the competitive product or products, the defendant sold the competitive product or products below its average variable cost of producing them.

The court does ‘not believe that the recoupment requirement from single product cases translates to multi-product discounting cases’. The standard adopted in the PeaceHealth decision does not adequately protect a firm that engages in bundled discounts that are competitively neutral or pro-competitive, because it rejects the complete conceptual logic that is the basis for both prongs of the Brooke Group standard. The PeaceHealth pricing test would implicate as anti-competitive discounts of a level that can be explained by competition and could be consumer welfare enhancing. It also does not require any probability of recoupment.

First, unlike the Brooke Group price-cost test, which requires that a price cut be so large that it makes no economic sense in the short run for the producer, the PeaceHealth discount attribution standard could include price cuts that were fully explained in the short run by a desire to price discriminate.

Second, even though firms have legitimate reasons for pricing in a way that would fail the discount attribution price-cost test, the court rejected the need for the presence of recoupment to cause consumer harm. Thus, this test could find liable firms engaging in a bundled discount programme that does not cause consumer harm through exclusion. Recall that a firm could be losing relative profit by bundling discounts instead of not bundling them. During this time consumers are enjoying lower prices. In the absence of assessing the potential for recoupment, the court confuses harm to competitors with harm to competition, where harm to competition implies that consumers were harmed as a result of the exclusion of a rival.

The PeaceHealth decision adopted a price-cost test that a defendant engaging in pro-competitive bundled pricing could fail and rejected the need for recoupment. In doing so, the decision adopted a standard that could not only find liable defendants engaging in pro-competitive bundling, but more importantly and more devastatingly for consumers, it could (and most likely will) chill price competition.

Antitrust Modernization Committee

The Antitrust Modernization Committee (AMC) made an attempt in 2007 at creating rules that would provide some clarity to the challenge of defining when a bundled discount could be anti-competitive. In its attempt the AMC made the following recommendation:

Courts should adopt a three-part test to determine whether bundled discounts or rebates violate section 2 of the Sherman Act. To prove a violation of section 2, a plaintiff should be required to show each one of the following elements (as well as other elements of a section 2 claim): (i) after allocating all discounts and rebates attributable to the entire bundle of products to the competitive product, the defendant sold the competitive product below its incremental cost for the competitive product; (ii) the defendant is likely
to recoup these short-term losses; and (iii) the bundled discount or rebate programme has had or is likely to have an adverse effect on competition.

The first prong of the AMC test is the price-cost test adopted by the PeaceHealth court. As discussed above it alone would not satisfy the logic of the single product price-cost test in Brooke Group because firms adopting pro-competitive or neutral price discounts could fall outside this price-cost safe harbour. Moreover, implementation of the first prong provides room for interpretation, as it does not specifically address how discounts should be allocated across multiple competitive products in the bundle, or how to identify incremental costs when economies of scope exist.

Although the second prong of the AMC test (likely recoupment) seems on its face to have the potential to provide what was missing in PeaceHealth (i.e., the need for the bundled discount to lead to higher prices in the future that are recouped by the discounting producer and ultimately harm consumers) in application it does not. AMC Commissioner Jonathon M Jacobson clarified that the AMC recoupment standard would be met if the entire bundle was sold at a profit (i.e., the total price of the bundle was above the total incremental cost of producing it). The apparent logic is that in this circumstance there are no ‘losses’ for the producer to recoup, and thus a standard recoupment test need only be conducted if the entire bundle was priced below cost. In this form, the AMC recoupment test does not conceptually or formally address the recoupment that would be necessary for the bundled discount to cause harm to consumers. In addition, it means that in practice the second prong likely does not require plaintiffs to prove anything more than was required by the PeaceHealth decision.

The AMC recoupment standard does not reflect the underlying conceptual logic in the Brooke Group recoupment standard, which required that consumers will likely be harmed, and the discounting firm benefited, by future higher prices. By concluding that a firm has recouped if its entire bundle is sold above incremental cost, the AMC has adopted a recoupment standard that in most bundling cases will not require there to be actual harm to consumers. Commissioner Jacobson acknowledges this and notes that showing harm to competition would have been ‘the main benefit of the competitive-product-only approach’, in which plaintiffs would have to show that the firm was likely to recoup the lost profits on the monopolised good. He states that this ‘is something the AMC’s approach captures fully in part three of its test’, which he believes is the most important prong.

The third prong states that ‘the bundled discount or rebate programme has had or is likely to have an adverse effect on competition’. The broadness of this third prong is evidence of the challenge of defining when a bundled discount could in fact cause harm due to exclusion. For example, the loss of a single product competitor in and of itself cannot and should not be sufficient, as it could be the result of competition. In Commissioner Jacobson’s explanation of the third prong, he alludes to the need to show the type of recoupment traditionally required in the analysis of single product predation.

Ultimately because the AMC guidelines do not specifically define ‘adverse effect on competition’, there is still much room for debate. This is highlighted by Commissioner Jacobson’s explanation of the third component of the AMC test. Although the AMC test is a move in the right direction (because it would offer at least some firms a safe harbour through the price-cost test), the courts are still required to offer a great deal of individual judgment when deciding what is necessary to distinguish competitive bundled discounts from those that are anti-competitive. This is evidenced by the fact that the PeaceHealth court had the benefit of the AMC report, yet it still rejected the need for a recoupment standard. It based its choice on its belief that there are theoretical models in which a firm can exclude at no cost, but failed to recognise that these models do not show any harm to consumers.

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Bundling is a form of price discounting that can - and usually does - benefit consumers. It is important not to over-deter bundled discounts that can benefit consumers. Failing to offer adequate protection to firms that offer pro-competitive and competitively neutral bundled discounts, could chill legitimate price cutting. The law still does not provide meaningful guidelines on determining the recoupment required to harm consumers. The existence of future recoupment is crucial for bundled discounts to be considered anti-competitive through exclusion; otherwise they are simply price discounts that have benefited consumers.
Notes

1 LePage's Inc v 3M, 324 F.3d 141 (3d Cir. 2003), cert. denied, 124 S. Ct. 2932. 
3 Cascade Health Solutions v PeaceHealth, 502 F.3d 895 (9th Cir. 2007) 
4 Firms without monopoly power or significant market power may also use bundled discounts to price discriminate. 
5 In the previous example, if the stand-alone monopoly price for product A is $10, then the bundle would make consumers better off. But if the monopoly price is $8, consumers willing to pay $10 would be worse off. 
6 The firm does not make any profits on B because if it sells B then it will sell it at the competitive price, which is equal to the marginal cost of producing B. 
7 Some academic papers, such as Nalebuff (2004) and Greenlee et al (2006), state they have created models of exclusionary bundling with simultaneous recoupment. But these models are in effect tying models and rely on restrictive assumptions that are rarely applicable in the real world. The results of Greenlee et al. (2006) heavily rely on the assumptions that (i) the defendant does not face any competition in the market for product A, (ii) all (or almost all) customers that wish to purchase A also demand B and (iii) the competitive product B is perfectly homogeneous. Under these restrictive conditions the monopolist in product A finds it profitable to raise its a la carte price to a point at which no customer is willing to purchase it outside the bundle, which is effectively tying the two products. The authors note that when the competitive product is not homogeneous, bundling serves as a price discrimination mechanism and not as a form of tying, and bundling can increase consumer welfare. ‘If the rivalrous market is differentiated product duopoly rather than characterised by homogenous goods, bundled discounts are not equivalent to tying. In such cases, profit-maximising loyalty programs have ambiguous welfare effects, and aggregate consumer surplus can rise or fall due to bundling.’ (Greenlee et al, page 5). There are very few examples of absolute monopolies and perfectly competitive, homogeneous product markets. It follows that one should not use Greenlee et al’s exclusionary model as a general guide to determine antitrust policy. Nalebuff’s (2004) model is similar to Greenlee et al’s except that the firm offering the bundle increases its profits at the same time that ‘consumers who choose the tying contract must be better off’. (page 6) See Patrick Greenlee, Reitman, David S and Sibley, David S ‘An Antitrust Analysis of Bundled Loyalty Discounts’, Economic Analysis Group Discussion Paper No. 04-13 (Revised), 30 October 2006 and Barry Nalebuff, ‘Bundling as a Way to Leverage Monopoly’, Yale School of Management Working Paper Series, ES Economics Working Paper 36, New Haven, Conn., 2004. 
8 Brooke Group Ltd v Brown & Williamson Tobacco Corporation, US 509, 
9 Ibid, page 222. 
10 Areeda and Turner conclude that marginal cost is the appropriate level of cost, but they note that ‘[t]he incremental cost of making and selling the last unit cannot readily be inferred from conventional business accounts, which typically go no further than showing observed average variable cost’ and thus they advocate using average variable cost. See Phillip Areeda and Donald F Turner, ‘Predatory Pricing and Related Practices Under Section 2 of the Sherman Act’, Harvard Law Review 88, page 716, 1975. In its Matsushita decision, the Supreme Court cited Areeda and Turner when it noted that it was only necessary to ‘consider whether recovery should ever be available […] when the pricing in question is above some measure of incremental cost’; Matsushita v Zenith Ratio Corp 475 US at585, n. 9. The Second, Fifth, and Eighth circuits have adopted average variable cost standards; see Ne. Tel Co v AT&T Co, F.2d 76, 87-88 (Second Circuit, 1981), Stearns Airport Equip. Co v FMC Corp, 170 F.3d 518, 532 (Fifth Circuit, 1999), and Morgan v Ponder, 892 F.2d 1355, 1360 (Eighth Circuit, 1989). 
11 ‘[T]he exclusionary effect of prices above a relevant measure of cost either reflects the lower cost structure of the alleged predator, and so represents competition on the merits, or is beyond the practical ability of a judicial tribunal to control without courting intolerable risks of chilling legitimate price-cutting.’ Brooke Group US 509, page 223. 
12 Ibid, page 223. 
13 Ibid, page 224 
14 Ibid, page 224 
15 LePage's Inc v 3M, 324 F.3d 141 (3d Cir. 2003), cert. denied, 124 S. Ct. 2932, page 154. 
16 Ibid, page 155. 
18 Cascade Health Solutions (fka, McKenzie-Willamette-Hospital) v PeaceHealth No. 05-35627, D.C. No. CV-02-06032-ALH, page 11221.
20 ‘The recoupment part of the test might be conducted in two ways. One would be to determine whether the defendant would be likely
to recoup by comparing future revenues to costs for the competitive product only, and to do so under the same attributed revenue
basis as applied under part one of the test. The other would be to determine whether the bundled pricing strategy as a whole would
result in recoupment of the attributed losses. The AMC test is based on the latter approach. Under that approach, the recoupment
requirement will come into play only in those circumstances where the bundled pricing arrangement fails the first screen of the
AMC test and is such that the price of the bundle is below the incremental cost of all the products in the bundle. Otherwise, there
will be no actual losses for the defendant to recoup.’ Jacobson, Jonathon M ‘Exploring the Antitrust Modernization Commission’s
23 Ibid, page 2.
24 ‘The most important component of the AMC’s test is its third part, the requirement of actual or probable harm to competition - ie,
a basic rule of reason test. Given that many package discounts will fail both the below-cost and recoupment safe harbors, it is
especially important to ensure in applying the third part of the test that there be solid evidence that competition in a relevant market,
considered as a whole, has been harmed. This means proof that market prices have increased or will increase, or that market output
has been or will be reduced, or other material consumer harm.’ Ibid, page 6.
25 PeaceHealth, page 11234, note 21. The court relies on a model proposed by Barry Nalebuff in the Antitrust Bulletin. In this model,