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Going Soft on Microsoft? The EU's Antitrust Case and Remedy*

Ian Ayres and Barry Nalebuff

Summary

In March 2004, following a five-year investigation, the European Commission found Microsoft liable for illegally tying the Windows Media Player to the Windows operating system. This Column evaluates the antitrust issues and the proposed remedy. What is remarkable is that the remedy eliminates false positives. Just as King Solomon's proposal to divide the baby only caused pain to the true mother, the Commission's remedy will only cause pain to a monopolist who abused its position.

KEYWORDS: Bundling, tying, antitrust, Windows, Microsoft, EU Commission

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Introduction

For the first time in its history, Microsoft is being forced to change its products in response to an antitrust action. The European Commission ordered Microsoft to sell a version of the Windows operating system without the Windows Media Player (WMP) built in. Microsoft can continue to sell Windows bundled with WMP. But it can't sell the version of Windows with WMP for *less* than the version without it.

Microsoft's attempt to stay the order pending the result of its appeal was recently denied. This means that the Commission's order will be in effect during the appeal, despite the fact that Microsoft could win in the end. As a result, Europeans will soon see the unbundled version of Windows in the market.

The media player market isn't just about music. This is a battle about the future of Digital Rights Management — about what operating system will appear on your next mobile phone or TV. WMP is already on over 90 percent of all Windows machines. And, as a result, most media streams these days are now encoded in the Windows Media format.

If this trend continues, when digital media get delivered to other platforms beyond the PC, there won't be effective competition in the player market — for all content will be in Microsoft's proprietary WMP format. Back on the PC platform, if WMP format becomes the standard, the fact that WMP is not platform-independent reduces the threat from Linux.

The stakes in this game are high: Will Microsoft be able to add the world of digital media to its empire?

In this essay, we will argue that the Commission was right to find an antitrust violation, but that it did not opt for the best remedy to address the violation. However, it was the right call to impose the proposed remedy pending Microsoft's appeal of the Commission's order.

The European Commission's Decision and the Appeal

Last March 2004, following a five-year investigation, the European Commission found Microsoft liable for illegally bundling WMP to the Windows operating system. Along with ordering Microsoft to sell a version of Windows

without its media player, the Commission also fined Microsoft a record €497 million.

Microsoft appealed the decision to the Court of First Instance and asked the Luxembourg Court to suspend the remedy until its appeal is resolved. The Commission replied that justice delayed is justice denied — by the time the appeal is over, the market will have tipped, and Microsoft's monopoly will have extended to include media players.

On December 22, the Court of First Instance President Bo Vesterdorf agreed with the Commission and upheld the remedy while the appeal is being decided. Over this interim period, Microsoft must sell a version of Windows without its media player. The OEMS who sell machines with this version will have the option of choosing to match it with alternative media players, such as Real Player.

Microsoft Is Not Bundling To Increase Its Current Windows/Media Player Profits

Microsoft is “bundling” its Windows operating system with its Media Player, by selling the two together. But why? A Chicago School¹ analysis suggests Microsoft would not gain from doing so, at least if we look at this as a one-off game, without considering future upgrades and the like.

To see why, let's assume that Microsoft has a monopoly in Windows and that the value of Windows is \$100 to all customers. Assume, too, that Windows is an essential product so that a media player is worth nothing without Windows. Let the value of WMP be \$2, and the value of Real Player be \$3. (For simplicity, all products have zero cost.)

Microsoft should not want to tie its products. Real will not abandon the market until its price is zero. With a zero price for Real Player, Microsoft could charge \$103 for Windows, as consumers value the package of Windows plus a free Real player at \$103. In contrast, a bundle of Windows and WMP is only worth \$102.²

¹ The Chicago School of Antitrust grew up in the 1950s at the University of Chicago inspired by the late Aaron Director. Since then, it has had enormous influence on American antitrust jurisprudence.

² In order to push the price of Real Player down from \$3 to below \$1, Microsoft needs to give away WMP. Having done so, they should then facilitate the adoption of Real Player.

The Real Reason Microsoft Is Bundling: Preempt Operating System Competitors

So, why bundle? One answer is that the software bundle saves costs and enhances functionality. Another answer is that Microsoft is concerned with something other than its direct profit from sales of WMP — and what it is concerned with is ensuring the continued market domination of Windows. The complementary product market is a threat in that it could be used as an entry point into operating system software.

Consider an analogy: In the browser market, Microsoft feared that Netscape would use its platform to enter and compete against Windows. Hence, Netscape had to be eliminated.

Microsoft asserts that this case is different, for a media player is much less likely to morph into an operating system than a browser is. But keep in mind that whether a media player could threaten the PC version of Windows is not the only relevant question here; there are operating systems for mobile phones, TV set-top boxes, and handheld devices, too.

The pressing antitrust concern here is that Microsoft will use its power in Windows to eliminate Real and other rival media players. The end result will be that the player market will tip to Microsoft's propriety standard. A monopoly in the player market will lead to a monopoly in the encoding market, and this virtual circle will extend Microsoft's dominance to the world of digital media.

Another Possible Microsoft Motivation: Capturing Upgrade and Switching Costs

Recent work by Carlton and Waldman (2004) develops a further antitrust issue, namely that the monopolist is unable to capture the value of upgrades and switching costs on the complementary product — unless the complement is its own.³ This leads the monopolist to exclude rivals, even when the rivals are more efficient.

³ See Carlton, D.W. and M. Waldman, "Bundling, Switching Costs, and Upgrades," Work in Progress, 2004. Note also that if the rival in the complementary market were to develop a monopoly in that good, and that good were to become essential, then the rival would also have a claim to the entire pie. For example, Microsoft competes with Intel over how the Wintel pie will split. Microsoft would prefer to avoid having a third player at the table.

Even if consumers value rival media players more, Microsoft might opt to take a hit by bundling Windows with WMP. It can recoup the value lost in the initial sale by capturing more of the value of upgrades and switching costs related to WMP. For upgrades, Microsoft can charge directly — consumers pay for the enhanced version of WMP. Meanwhile, switching costs will deter consumers from adopting a competing media player once they already have invested in WMP (and its upgrades).

Microsoft's Defenses of Its Bundling Are Unconvincing

Microsoft argues that its motivation for bundling is cost savings and standard setting. While having one standard certainly lowers costs for suppliers and consumers, that doesn't justify allowing a monopolist to lever its market power (here, in the operating systems market) to create a proprietary standard in a complementary market (here, in the media player market).

It's one thing for an industry association to set a standard. It's also fine for competing standards to duke it out. But why should a monopolist in one market be allowed to use its power to set a proprietary standard in a second market? Potential costs include setting the wrong standard and reduced incentives for innovation, along with all the inefficiencies associated with establishing a monopoly in the second market.

The Commission's Unbundling-Only Order: Was It the Right Option?

As noted above, the European Commission ordered Microsoft to sell a version of Windows without WMP — in other words, to unbundle its products. The point of the remedy is to stop the illegal action as well as to restore a level playing field. Here, the Commission could have done better.

A better remedy would have been to *combine* the unbundling with a "must-carry" approach. As is currently the case, Microsoft would be required to sell a version of Windows without WMP. But there would be a second Commission-imposed condition: the version of Windows that Microsoft sells *with* WMP would be required to include three other media players built in (two selected by the Commission and one by the OEM, such as Dell or HP).

In the settlement negotiations prior to the Commission's decision, Microsoft offered some versions of the "must carry" approach, but as an

alternative (not an add-on) to unbundling. Our solution, in contrast, is an add-on: Microsoft would have to do both.

According to press reports, Microsoft first proposed that the rival media players would be included in a companion CD.⁴ That, of course, would not create a level playing field — less-informed consumers might simply ignore the companion CD, and even well-informed consumers might pass, not wanting to spend the time on installation. Apparently, Microsoft later offered to preinstall three rival players. The Commission would choose two and the OEM would get to choose the third.⁵

Even if it doesn't solve the entire problem, the must-carry approach seems to be a good idea. It helps increase the availability of rival media players and thus restores some of the level playing field.

What is the harm of having an extra media player on the machine, be it the Windows player or one of the rivals? One issue is that the extra players take up valuable disk space. But, the size of a media player is around 10 megabytes and with 60-gigabyte drives, this cost seems practically irrelevant. Another possibility is that the existence of multiple media players increases customer support cost, both for Microsoft and for the OEM. That strikes us as plausible.

To our mind, the real problem with must carry is that it doesn't go far enough on its own. At first glance, it might appear that with multiple players preinstalled, the result would be level playing field. WMP would be just one on a menu of options from which all consumers would choose, not an automatic "default." Not quite. The other options would vary, and WMP would be a constant.

Thus, must carry alone would not have solved the underlying problem: *Microsoft would still have the unique ability to ensure that its media player would be on all new machines — and thus eventually on all machines.* That, in turn, would mean that a content provider that encoded its content in the WMP format would be ensured nearly 100% reach in the market. And that content provider would have little incentive to engage in "dual encoding" — that is, encoding in a number of different formats.

⁴ See <http://www.windowsitpro.com/Article/ArticleID/42040/42040.html>.

⁵ See <http://www.zdnet.co.uk/print/?TYPE=story&AT=39150622-39027001t-21000014c>

The result: Content will only be encoded in WMP format. Microsoft will have a virtuous circle between its player and digitized content. Rival players may hang on, but only if Microsoft deigns to license its decoder. Microsoft will make all the rules.

The Key: Retaining Incentives for Dual Encoding

So how can we motivate content providers to engage in dual encoding, and ensure that WMP format does not dominate the market as a result of Microsoft's monopoly in Windows?

The answer is that content providers must believe that the alternative formats are less expensive or of superior quality, or that the alternative formats will extend their reach — allowing them to connect with consumers who would otherwise have been outside their markets.

For this to happen, other media players must remain viable in the market, and some people must *not* have WMP on their machines. Thus, the Commission was right to go beyond Microsoft's must-carry plan.

If even a small number of people — and it's the absolute number, not just the fraction — don't have WMP on their machines, many content providers should find it worthwhile to engage in multiple encoding. And then consumers will have a reason to use alternative media players, assuming their quality is superior or their price is lower, since content will be as likely (or almost as likely) to be playable on a rival media player, as it is on WMP. And for now, at least, those rival players can license WMP decoders and thus also play WMP files.

The Commission picked unbundling over must carry. If they had to choose, they chose correctly. But there was no need to pick one over the other. They could have done both.

What the World Will Look Like When Microsoft Must Unbundle

Microsoft attacked the Commission's unbundling order on a number of grounds, but none is convincing. To see why, let's first look at the world after Microsoft begins to comply with the order:

First, given that Microsoft is giving away WMP today, we can expect that they will continue to give it away for some time. That suggests that the bundled and unbundled versions of Windows will cost the same amount.

So why buy the unbundled version of Windows? Because it will be just as good — or, in the eyes of some, better. It will be sold with a rival player, say Quicktime or Real. And Real can do everything WMP can, including playing Windows Media files and displaying album cover art. (To do so, Real licenses some of Microsoft's code.)

From the end user's point of view, then, choosing the unbundled version may make sense. In any case, the real customers are not end users, but rather Dell and other OEMs. Rival players may provide financial incentives to these OEMs to establish their player as the default option. (The rivals can recover those payments through upgrades, or through the sale of subscription services marketed through the player.) End users, too, will benefit, as some of these incentive payments will be passed on in the form of lower hardware costs. Thus OEMs and end users may choose the unbundled version of Windows because, after incentive payments, it's cheaper.

Note, though, that Microsoft can't play the same game. They can't offer OEMs or end users a financial incentive to make WMP the default, or engage in any similar machinations. They are specifically prohibited by doing so by the Commission's Order as that would make the bundled version less expensive than the version without it. Indeed, this restriction on pricing may be the most biting part of the remedy.

According to the Commission decision, paragraphs 1012 and 1013:⁶

Microsoft must refrain from using any technological, commercial, contractual, or any other means which would have the equivalent effect of bundling WMP to Windows. ... Microsoft must not give OEMs or users a discount conditional on their obtaining Windows together with WMP ...

⁶ The full decision is available at www.europa.eu.int/comm/competition/antitrust/cases/decisions/37792/en.pdf

Why Microsoft's Arguments Were Unpersuasive

In the Court of First Instance, Microsoft fought the Commission's decision full force. They didn't want the precedent of having the court dictate what options are provided as part of their operating system. But that argument was unlikely to persuade the court. Thus Microsoft offered three arguments regarding the merits.

First, Microsoft claimed its reputation would be irreparably harmed by the mere existence of a Windows system that might not come with all the WMP functionality, such as tagging album cover art to music files. But that's far-fetched. Dell and other OEMs won't sell Windows with a non-functional media player.

Second, Microsoft claimed that the remedy will make customers run around in circles. Why take Windows Media Player files off the machine just so that users will put it back on themselves later? But not all will, especially if rival formats get established. The reason to go through this convoluted process is to allow competition. If Windows Media Player code automatically comes on all machines, then content providers know that they only have to encode in one format. Again, the key is to ensure a critical mass of machines *without* WMP — enough to ensure content providers and web sites will find it worthwhile to dual encode. As noted above, even a relatively small number of machines that don't come with WMP will be enough to preserve competition in the market.

Third, Microsoft argued that allowing different versions of Windows will require web sites — at great expense — to make their media streams compatible with multiple media players rather than just the de facto WMP standard. But the cost to third parties is not a legal justification for staying a remedy. As the Court ruled:⁷

... the urgency of an application for interim measures must be assessed in relation to the necessity for an interim order in order to prevent serious and irreparable damage to the party applying for those measures ... Consequently, in so far as the uncertainty on which Microsoft relies may cause damage to third parties, it cannot be taken into account under the head of urgency.

⁷ Paragraph 416 of Order of the President of the Court of First Instance, 22 December 2004, Proceedings for interim relief—Article 82 EC) in Case T-201/04 R, available at [www.curia.eu.int/jurisp/cgi-bin/gettext.pl?lang=en&num=79958777T1904%20R0201_2&doc=T&ouvert=T&seance=ORD&where=\(\)](http://www.curia.eu.int/jurisp/cgi-bin/gettext.pl?lang=en&num=79958777T1904%20R0201_2&doc=T&ouvert=T&seance=ORD&where=()).

Economics suggests another reason to ignore these costs: websites will only spend resources if the alternative versions of Windows succeed in the market. If these versions succeed, that is the best evidence that Microsoft abused its power by forcing all Windows customers to take Microsoft's media player. Website developers might prefer the simpler life of one standard, but we can't deny the costs of competition to support an ill-gained monopoly.

The Court Was Right to Allow the Order to Take Effect Immediately

In criticizing the proposed remedy, Microsoft fatally undercut its argument for the stay. Microsoft claimed that there would be little commercial demand for the “Article 6” version of Windows without WMP. As the Court of First Instance recognized in its decision, that claim was fundamentally inconsistent with Microsoft’s argument that imposing the remedy would lead to a high probability of serious and irreparable harm.⁸ An ineffective remedy is unlikely to cause irreparable harm.

At the end of the day, Microsoft might be right and the remedy could have no impact. In that case, the cost is minimal, especially as Microsoft has already done all the work to create the alternative version of Windows.

Conversely, however, if the remedy *does* have an impact, this means that the Commission got it right — Microsoft's success with WMP was not based on the merits, but on the skewed playing field created by its tie. Indeed, seeing the remedy have an impact would be very useful information to the Court in deciding the appeal.

What is remarkable is that the remedy eliminates false positives. In short, we don't have to know if Microsoft will win the appeal or not or even if the remedy will work or not. All we need to know is that if the remedy does have any impact, that's a sure sign that Microsoft abused its position and hence we should be happy to have the remedy in place. Just as King Solomon's proposal to divide the baby only caused pain to the true mother, the Commission's remedy will only cause pain to a monopolist who abused its position.

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⁸ Paragraph 426–449 of Order of the President of the Court of First Instance, 22 December 2004.

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References and Further Reading

The March 24th European Commission decision is available at europa.eu.int/comm/competition/antitrust/cases/decisions/37792/en.pdf

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