The American Consumer Institute

FAQs about Price Discrimination and Consumer Welfare

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Summary: Debate over whether to regulate Internet Service Providers has raged during consideration of so-called "Net Neutrality" (NN) legislation now pending in Congress. The "D" word – for price discrimination – is at the heart of the case for NN neutrality legislation and measures to prevent it are the centerpiece of legislative proposals being pushed by NN advocates. This ***ConsumerGram*** *addresses frequently asked questions (FAQs) about the practice of price discrimination. The answers suggest that price discrimination is common throughout American industry; is particularly prevalent among Web-centric firms; is quite lawful, absent specific harm to competition; does not require monopoly power; is widely supported by welfare economics and analysis; is necessary for efficiency and welfare maximization in most settings; and, overall, improves consumer economic welfare.*

Q: Stripped of economic jargon, what does price discrimination mean?

A: The term is used loosely and its meaning varies with context. Generally, price discrimination involves charging different users different prices for similar services or charging the same price for services with different costs. It may refer to charging according the value of a service to end users, rather than the cost of service to the provider. The term appears in the NN debate to describe the offer of different grades/types of network access at different prices to different customer classes.

Price discrimination entails a two step process: (a) separation of markets into classes of users; and (b) price differentiation among users in different classes. Examples of price discrimination include discounts for seniors, students, volume buyers, off-peak users, and frequent buyers. Conversely, price discrimination is reflected in offers of premium quality, preferred access, faster/better customer care, or other superior attributes.

Q: Is this bad? What do experts have to say about the incidence of price discrimination?

A: The consensus: Price discrimination is the rule, not the exception, experts say:

- "Price discrimination among buyers…is …routine even in highly competitive markets, including hotels, computers, automobiles, books, clothing, groceries, restaurants, telecommunications, and the vast range of other products that offer coupons, rebates, student or senior discounts, quantity discounts, or different prices

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at different times or places. Indeed, it is hard to think of industries without price discrimination...” (Einer Elhauge, *Yale Law Journal*, v. 12 at 733.)

- “Price discrimination is one of the most prevalent forms of marketing practice.” (Hal Varian, *Handbook of Industrial Organization*, at 598.)
- “…price discrimination is common in many industries…” (William Baumol, *Regulation Misled by Misread Economic Theory*, 2006, at 1.)
- “…pricing structures designed to accomplish segmentation [among users and uses] are widely used…in the economy.” (Michael Levine, “Price Discrimination without Market Power,” *Yale Journal on Regulation*, 2001, at 2.)

Market “segmentation,” “clustering,” “differentiation,” “separation,” and “classification” are terms commonly found in marketing textbooks, consulting reports and product pricing discussions. As a practical matter, there is no consistent, principled distinction between price discrimination and price differentiation or variation among similar goods and services.

Q: Do Web-centric companies practice price discrimination?

A: Market segmentation, customer clustering and price discrimination are widespread among Web-centric and goes by various names – “versioning,” “promotional pricing,” “discounting,” “clearances,” “introductory offers,” to name a few. The practice is readily confirmed by information provided in marketing materials and price lists issued by Intel, Microsoft, Dell, ComCast, eBay, Amazon, Google, AT&T, Amazon, Verizon, Yahoo! or most online commercial vendors.

Q: Are there specific instances of price discrimination by Web-centric companies?

A: Professors Shapiro and Varian identified several different forms of what they called product or service “versioning” (Carl Shapiro and Hal Varian, *Information Rules*, Harvard Press, 1998, Ch. 3). Practices equivalent to so-called “access-tiering” opposed by NN advocates are common in most other sectors of the economy. These include:

- *Delay*: Delayed stock quotes are given away, while a real-time feeds are costly.
- *User interface*: “Professional” versions have more elaborate user interfaces than popular versions.
- *Convenience*: Low-price versions are harder to use than simpler high-price versions.
- *Image resolution*: Low-resolution images sell for less than high-resolution images.
- *Speed of operation*: The low-speed version is cheaper than higher-speed versions.
- *Flexibility of use*: Low-end software has capability compared to high-end products.
- *Capability*: Professional versions “can do more things” than low-end versions.
- *Features and functions*: High-end versions have more “bells and whistles.”
- *Comprehensiveness*: High-end databases or information service may be more complete and wide-ranging than the low-end.
- *Annoyance*: The low-end product uses “nagware,” such as start-up delays or reminders, to induce the consumer to upgrade to a more expensive version.
- *Technical support*: Low-end products get less support than high-end products.

Curious and observant consumers can find other instances of market segmentation, customer clustering, product variation, and discriminatory pricing in the web-centric marketing pitches.

Q: Does price discrimination violate any U.S. law or administrative rule?

A: It is not, *per se*, a violation of any law or rule governing US commerce. Price discrimination is a violation only if it creates or leads to a specific economic harm. Thus, for example, price discrimination may run afoul of antitrust laws if the practice harms competition or creates monopoly. Common law traditions embedded in traditional public utility regulations (imposed historically on monopolies in transportation, energy, communications and other sectors) hold against discrimination, but allow, or even promote, numerous forms of differentiation of price among classes of users (business vs. residential); type of service (local vs. long distance), location (rural vs. urban); time of day (peak vs. off-peak). In public utility regulatory proceedings, undue, unjust, unfair or otherwise unlawful discrimination is frequently alleged, but seldom found by regulators.

Q: Why do businesses practice price discrimination?

A: Reasons vary, but center on the nature of company costs, most of which are variously described as indirect, overhead or common costs. Such costs are not caused by a particular service or customer, but rather are incurred on behalf of all customers and services. Common costs -- wages, interest, rent, supplies, equipment, insurance, R&D and so forth -- tend to comprise a larger share of the total in web-centric businesses. To illustrate, consider for a moment all the different costs incurred by a telephone company or a cable company and what proportion of those you personally caused and should be accountable for paying in your monthly bill. You personally caused very little of that cost, most of which was incurred in order to give you and others the opportunity to obtain service. Such is the nature of most "network" costs.

Common costs tend to be front loaded (think of building a network or a national business). Another feature of cost is that the added cost of serving the incremental customer is modest. What, rhetorically, does it cost Google or Microsoft or Verizon or eBay or Amazon to add one more customer or to add a new service? Firms typically raise prices above these incremental costs in order to make a contribution to the common or overhead costs. For most web-centric companies, pricing according to the costs added for each new customer would result in total revenue less than total cost. The company would fail. Firms with high common costs and low cost for serving an additional customer must differentiate prices in ways that allow them to cover the overhead of the whole business. The result is invariably what we have called "price discrimination."

Q: *Wouldn't consumers be better off if everybody paid the same price?*

A: No. Users differ according to their respective ability and willingness to pay for the same or similar services. (Compare yours with friends and family.) Company pricing specialists in most industries – airlines, clothing, publishing and book retail, software, computer equipment, movie theatres, restaurants, grocery retailing, and on and on – have discovered that "average cost" pricing – wherein everybody pays the same share of common costs – will exclude from the market some buyers who would only be willing to pay a lower price that would cover <u>some</u> of the overhead costs and thereby reduce the burden on other customers. By varying prices according to values different users derive from services, companies have found that they can cover overhead, increase output, and serve more customers.

Q: But, doesn't this mean that some consumers pay more than others and are made worse off?

A: For sure, some may pay more than others. But, customers who pay more than average cost are better off than they would have been had the company gone out of business, or if they had to cover the overhead that would have been covered by the customers who would only have paid a lower price. (On my last domestic business flight I paid three times the average fare paid by other passengers – a family of five -- in my row. However, had they been asked to pay the average cost of the flight, they would not have taken that flight and I would very likely have been charged even more by an airline obliged to cover all its costs.)

Q: If markets were truly competitive, firms could not get away with price discrimination, right?!

A: Wrong! Market segmentation and differential pricing are not counter to market competition, but rather an integral part of the operation of market forces. In a wide variety of circumstances "…it is the very presence of effective competition that forces discriminatory prices on the firm." (Baumol at 2.) Uniform prices (that is prices that are not differentiated with respect to idiosyncratic demand characteristics associated with different uses) are NOT sustainable in most industry contexts. Put differently, competition often requires price discrimination.

- "Indeed, it is hard to think of industries without price discrimination… even though most…are highly competitive or contestable, and the firms in them earn zero economic profit (i.e., a normal rate of return)." (Baumol at 1.)
- "…in a broad range of market types and conditions, where consumers can be separated into distinct groups with different demand elasticities [willingness to pay]…, market pressures will prevent any equilibrium at which the price is uniform. Not only will each firm be forced to adopt discriminatory prices, but each firm is likely to be forced to adopt a unique… [structure]…of prices.., each of which is dictated by the market." (Baumol at 2-3.)
- . "…in highly competitive markets, firms may have no choice [but to practice price discrimination] …" (Baumol at 3.)

The consensus among mainstream economists is that price discrimination is not only compatible with effective competition and economic welfare maximization, but that it may be the only sustainable structure of prices for capital intensive, high sunk cost, low marginal cost undertakings. Banning natural pricing practices will suppress investment and consumer choice.

Q: Is there any evidence that consumers would be made better off if price and service differentiation by ISPs or other web-centric firms were banned by federal statute?

A: I have not seen any. The arguments for such a ban are anecdotal and metaphorical. More critically, they do not begin to consider the negative consequences for consumers of imposing it. Such consequences include delay and uncertainty about what prices firms can charge (inasmuch as legal tests are by consensus quite ambiguous) and resulting increases in risk, the cost of capital and, ultimately fewer choices, less quality and/or increased prices.

AUTHORITIES

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