

SHAPING COMPETITION POLICY IN THE ERA OF DIGITISATION

Groupe La Poste's Contribution to Panel 3's discussions:

PRESERVING DIGITAL INNOVATION THROUGH COMPETITION POLICY

Foreword: Innovation is a must-have in the digital world

As emphasized by Shelanski (2013)¹, “if there is any single force that best characterizes digital platform markets, it is probably the intensive and continuous investment in research and development to improve existing products and develop new platforms and applications”. According to him, in the digital world, R&D is the central input of production. In the digital world, firms are engaged in competition over innovation: they are trying to develop new products or services that will displace competitors' ones.

GAFA's R&D spending reflects this reality: in 2017, according to Recode², tech companies invested a combined total of \$76 billion. Amazon was at the top of U.S. companies list for R&D spending, with \$22.6 billion spent in 2017 on “technology and content”³ (the company's technology and content spending has increased by 41% compared to the previous year, doubled since mid-2015, quintupled since 2012 and is up tenfold since 2011). In this field, Amazon is followed by Alphabet (\$16.6 billion), Intel (\$13.1 billion), Microsoft (\$12.3 billion) and Apple (\$11.6 billion). Facebook rose from 13th place in 2016 to 9th in 2017 as it increased R&D spending 32% to \$7.8 billion.

Innovations in digital markets are sometimes radical but most often they are incremental, enhancing or significantly upgrading existing products or services. In the digital world, firms attract and retain consumers by changing the features and functionality of their products. For example, search engines constantly revise and refine the algorithms that match consumers' queries to search results. Social media platforms continually add features and make changes to optimize performance. Shopping platforms regularly introduce new interactive features using the information customers provide through such interactions. Even devices like smartphones and tablets regularly update themselves to improve performance and add capabilities before manufacturers introduce new models.

To compete with tech giants and to rise the challenge of the society's digitisation, actors of the “old economy” are also obliged to innovate. For instance, following the advent of the internet and other digital technologies, postal services have seen a steady decline in their core business of delivering letters. In response, postal operators are innovating to diversify their activities into a broad range of new service areas, to develop various digital and hybrid communication solutions, to accompany the growth of e-commerce, to increase the reliability of their networks, the predictability of their delivery services, and so on.

¹ Howard A. Shelanski (2013), Information, Innovation and Competition Policy for the Internet, *University of Pennsylvania Law Review*, vol. 161, pp. 1663-1705.

² Source: FactSet released by Recode: <https://www.recode.net/2018/4/9/17204004/amazon-research-development-rd>

³ According to Amazon annual reports, technology and content costs include payroll and related expenses for employees involved in the research and development of new and existing products and services, development, design, and maintenance of our websites, curation and display of products and services made available on our websites, and infrastructure costs. Infrastructure costs include servers, networking equipment, and data center related depreciation, rent, utilities, and other expenses necessary to support AWS [Amazon Web Services], as well as these and other efforts. Collectively, these costs reflect the investments we make in order to offer a wide variety of products and services to our customers.

Consequences on market structure and competition

Competition on the Internet is very often competition for the whole market, rather than competition for a share of the market through pricing. It takes the form of a race leading to the emergence of sequential monopolies that leapfrog each other, rather than simultaneous competitors that compete for market share. This type of dominance is not necessarily detrimental to consumers. On the contrary innovation may greatly benefit consumers and the only parties who might be “harmed” from innovation are those competitors that cannot keep up. According to Schumpeter (1942)⁴, “in such markets periodic dominance by one firm or a few firms may be symptomatic of healthy, innovation-based competition and may be subject to displacement, even when goods with network externalities are at issue. Creative destruction thus implies that antitrust policy based on static analysis of today’s market conditions can be misleading and, over time, injurious to consumers”.

Nevertheless, even if serial competition legitimizes monopolization or quasi-monopolization in innovation markets, it does not legitimize any interference with the cycle of “creative destruction”. In particular, nothing could justify strategy aiming to impede rivals’ ability to develop new products or services that threaten its dominance.

Consequently, competition authorities must sanction the dominant firm’s conduct when it is trying to exclude rivals’ or deter innovation and when the exclusion of rivals is not the natural result of innovative process. However, as recognized by Shelanski (2013), judging where introducing competition enforcement (in theory at the point where the costs of exclusion begin to outweigh the benefits of invention) is very difficult.

As explained by Shelanski (2013), two kinds of conduct would appear to harm innovation without constituting legitimate innovation: rivals’ costs rising and forced free riding. This first category of conduct comprises activities that impede rivals to offer competitive products or to introduce innovative/disruptive products. Forced free riding occurs when a platform appropriates innovations made by other firms which depend on the platform for access to consumers. Such conduct disincentivizes future downstream innovation: it sends the message that as soon as a firm develops a complementary product that is superior to the platform’s proprietary complement, the platform will snatch the improvements for itself. This conduct also removes the platform’s incentive to continue developing its own product, thus further magnifying the harm to competition.

How to manage innovation and competition in the digital era?

According to Tim Wu (2012)⁵, to promote innovation, antitrust law should fight against exclusion strategy. He considers that exclusion, if cheap enough, is actually an alternative to innovation, particularly for a monopolist. The cheaper exclusion is, the less reason a dominant firm has to invest in improving its products. There is a trade-off, in other words, between investing in innovation and investing in exclusion. So making exclusion expensive is the same thing as promoting innovation. In this regard, all policies against abuse of exclusion/exploitation as well as merger controls that prevent larger firms from acquiring highly innovative small firms in order to either capture or shut down their innovation efforts, have a clear role to play to promote both innovation and competition. An innovation-focused antitrust policy must make scrutiny of exclusion of innovators its primary concern.

⁴ J. Schumpeter (1942), *Capitalism, Socialism and Democracy*.

⁵ Tim Wu (2012), “Taking innovation seriously: Antitrust enforcement if innovation mattered most”, *Antitrust Law Journal*, vol. 78 (2), pp. 313-328.

A particular conduct that may raise competitive concerns is the observed appetite for acquisition of tech giants (sometimes fueled by a desire to suppress potential successors). Indeed, the GAFA have established their domination through their own innovation efforts and technological superiority but also through acquisition of firms either to monopolize their innovations or to prevent them to develop some innovation that would disrupt them. According to data compiled by Bloomberg, Alphabet, Amazon, Apple, Facebook, and Microsoft made 436 acquisitions worth \$131 billion over the last decade. For instance, Google also has amassed an impressive list of acquisitions: “innovation by merger” is responsible for many of Google’s most well-known services, including Google Docs (acquisition of Writely) or Google Maps (acquisition of Keyhole). Google’s entries into mobile communications and advertising markets are also based on acquisitions, of Android for the first case, DoubleClick, for the second one.

This appetite for acquisition could raise concerns if, as argued by Devine (2008)⁶, when a dominant firm like Google is allowed to acquire firms which produce related but potentially competitive products, it can control the direction and the rhythm of innovation for both product markets. As the dominant firm, Google is able to maintain its competitive advantage without having to innovate further or may choose to continue to innovate but will not feel pressure to bring those innovations to market as quickly as it otherwise might. Acquisition of innovative firms raises also competitive concerns when these entities may be future competitors or when once acquired by the dominant firm, a new technology is squashed, for fear that further development renders the dominant firm vulnerable to being overtaken by a competitor. Such situations seem similar to those where a firm hold a sleeping patent, a situation presumably detrimental to the society when its aims to block entry and protect the patent holder’s dominant position. Note that to fight against sleeping patents, in some countries and notably in the UK, the patent law provides for compulsory licensing of a new technology in cases where the patent-holder itself refuses to exploit it, despite market potential.

Last but not least, according to Ezrachi and Stucke (2017)⁷, the innovations made by tech giants may “work against the interests of consumers and markets, such as exploitative techniques to increase users’ engagement with their platforms or exclusionary elements”. They call this phenomenon the “rise of negative innovation”. They recommend as the market dynamic changes, to consider the beneficial or harmful nature of innovation.

Conclusion

Innovation must be at the core of antitrust scrutiny for two reasons. First, in the digital area competition is more and more based on innovation rather than on price as was the case in the old economy. Second, this innovation-based competition could raise concerns. In our view, there is a clear scope to apply theories of harm based on a loss of innovation and/or loss of potential competition more often.

Indeed, as in the old economy, but even more crucially in innovation-based markets, temporary dominance is the prize for which firms in “dynamic” markets compete. In this context, the difficulty for antitrust authorities is to find the right balance between a too strong antitrust policy that may have detrimental impacts on incentives and (financial) capacities to invest (and therefore lasting negative

⁶ Kristine L. Devine (2008), “Preserving Competition in Multi-Sided Innovative Markets: How Do You Solve a Problem Like Google”, *North Carolina Journal of Law & Technology*, vol. 10(1), fall, pp. 59-118.

⁷ Ariel Ezrachi and Maurice E. Stucke (2017), “e-Distortions: How data-opolies are dissipating the Internet’s potential”, in the Second Annual Antitrust and Competition Conference proceedings, *Digital Platforms and Concentration*, Chapter 1, pp. 5-7.

consequences for economic welfare) and a too weak antitrust policy that may also be detrimental to innovation due to the emergence of a dominant firm which would monopolize the market and threaten future innovations.

This presumes to have an increased scrutiny on firms' conduct and in particular merger activity. Indeed, thanks to their "deep pockets" or "long purses"⁸, tech giants have already multiplied acquisitions. They spend billions of dollars or euros to buy potential entrants (sometimes in order to kill them before they become effective competitors), to diversify their activities and conquer new niche markets or to vertically integrate the value chain of their original sector of activity, increasing their bargaining power vis-à-vis their suppliers or customers. Examples of newcomers that have attempted to compete with a platform in a platform market but that have been acquired by other giants, are numerous. One can cite for instance the case of Quidsi and Zappos acquired by Amazon, Jet.com acquired by Walmart, and the attempt of Facebook to buy Snapchat. The reasons which lead a giant to acquire a new entrant should be better analysed.

In this perspective, it may be useful to revise merger control guidelines. Purely turnover-based merger notification thresholds, which are used by the European Commission and most national competition authorities in the EU, are ill-adapted to merger control in the digital economy where companies may gain considerable market power without initially generating appreciable turnover. In this regards, the examples of German and Austrian competition authorities who have recently moved away from assessing mergers solely on turnover by introducing a "deal value" element to their merger rules⁹, merit careful thought.

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⁸ Thanks to their growing sales, to capital fund raising, to tax optimization mechanisms and other costs minimization processes, tech giants hold significant cash reserves (estimated to more than \$400 billion in June 2017). The market capitalization of these four companies is estimated to \$2.7 billion (source: <https://www.ecoreseau.fr/societe/enquete-societale/2018/05/14/jusquou-iront-les-gafa/>).

⁹ Bundeskartellamt and Bundes Wettbewerbs Behörde (2018), "Guidance on Transaction Value Thresholds for Mandatory Pre-merger Notification", May.