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What is Market Power and Dominance? Lessons from the *Google* case

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PART 1: What is “Dominance”?

What is “dominance”? -- The early structural view

- “freedom of action” :

*“economic strength enjoyed by an undertaking which enables it to prevent effective competition being maintained [or] power to behave to an appreciable extent **independently of its competitors, customers and ultimately of its consumers**”* (United Brands, Hoffman-La-Roche, Hilti)

- **Market share presumption:**

- *“very large shares are in themselves, and save in exceptional circumstances, evidence of the existence of a dominant position. That is the situation where there is a market share of 50%”* (AKZO)

- **Emphasis on market structure:**

- 40% share dominant if rivals small and fragmented (BA, United Brands)

- Rationale: Large supplier is “unavoidable trading partner” if small suppliers are not *“able to meet rapidly the demand from those who would like to break away from the undertaking which has the largest market share”* (Hoffmann-La Roche)

- Rebuttal possible if excess capacity, or no barriers to entry

The shift away from structuralism to “effects” analysis

- 2009 Guidance : Shift from protecting competitors to consumer welfare; from form-based to effects analysis – also relevant for dominance:
 - Move from market structure towards outcomes of a properly functioning market (*i.e.*, competitive prices, innovation and consumer welfare).
- No more market share presumption, but economic analysis
 - *“Market shares provide a **useful first indication** However, the Commission will interpret market shares in the light of the relevant market conditions, and in particular the **dynamics of the market** and of the extent to which products are differentiated. the higher the market share and the longer the period of time over which it is held, the more likely it is that it constitutes an important preliminary indication.”*
- Presumption reversed:
 - *“low market shares are generally a good proxy for the absence of substantial market power. ... dominance is not likely if the undertaking’s market share is below 40 per cent.”*

The Guidelines now focus on “power over price”

- *“an undertaking which is capable of profitably **increasing prices above the competitive level for a significant period of time** does not face sufficiently effective competitive constraints and can thus generally be regarded as dominant.”* (Guidance, note 1 para 11)
- *“the expression ‘increase prices’ ... is used as short-hand for the various ways in which the parameters of competition – such as **prices, output, innovation, the variety or quality** of goods or services – can be influenced to the advantage of the dominant undertaking and to the detriment of consumers.”*
- EC learned from OFT:
 - *“Market power can be thought of as the ability profitably to sustain prices above competitive levels or restrict output or quality below competitive levels. An undertaking with market power might also have the ability and incentive to harm the process of competition in other ways; for example, by weakening existing competition, raising entry barriers or slowing innovation. Assessment of Market Power, OFT 415, December 2004, para. 1.4:*

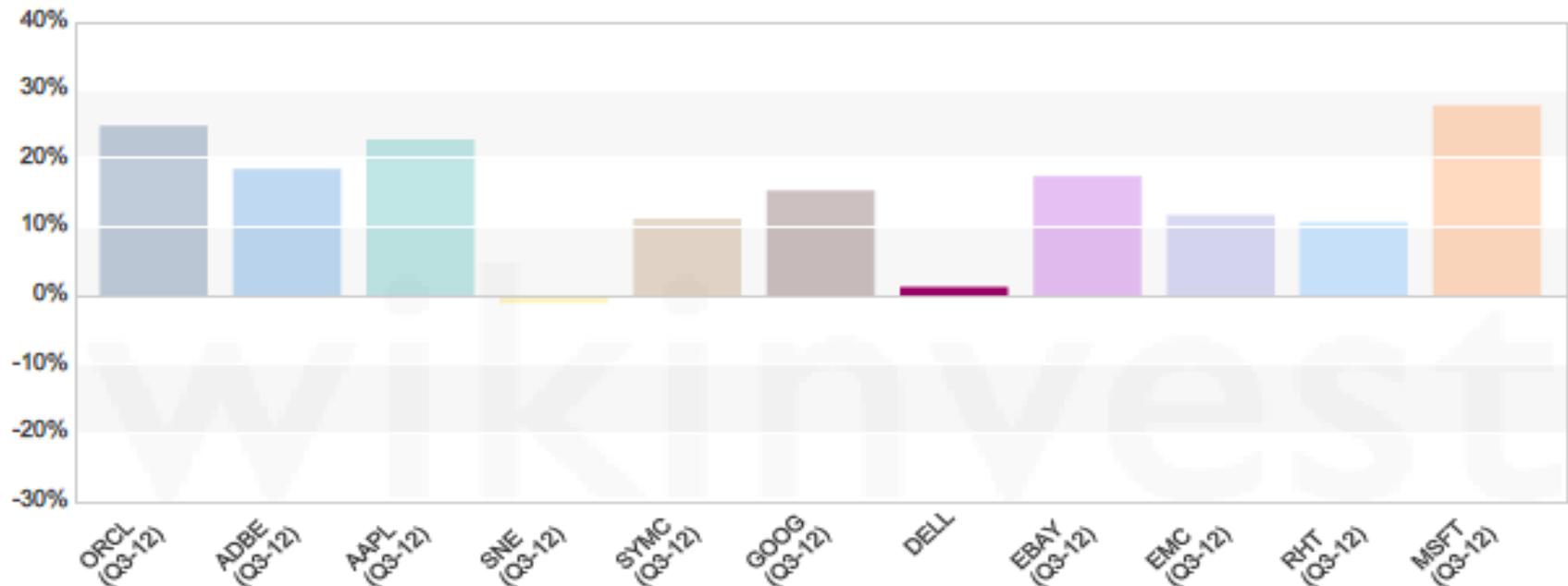
“Power over profit” instead of “power over price”?

- Most firms price $>AVC$ and $>LRAIC$, so price level not determinative
 - SSNIP test difficult since difficult to determine competitive price
 - “power to exclude” by “raising rivals’ costs” = power to raise price
- And in more and more cases, products are free for consumers
- Could **persistence of unusually high profits** be indicator? OFT:
 - “*persistent significantly high returns, relative to those which would prevail in a competitive market of similar risk and rate of innovation, may suggest that market power does exist. This would be especially so if those high returns did not stimulate new entry or innovation.*” (Market Power, OFT 415, December 2004, paras 1.7, 3.5, 6.5 and 6.6.)
- But “*low profit margin is not inconsistent with a monopoly situation, just as high profits can be consistent with a situation of effective competition.*” (United Brands).
 - Can be sign of inefficiency

High net profit does not suggest dominance

Comparison with Competitors NET MARGIN

Source: <http://www.wikinvest.com>



- Of course, comparisons must be made “per product”, not overall
- In industries with high sunk investment and ongoing innovation, high profit margins are consistent with a dynamically competitive market

Scarcity / Entrepreneurial Rents v. Monopoly Rents

- Net profit margins not the right criterion: Focus not on accounting profits but **economic profits**:
 - Revenues – (operating costs + opportunity costs of inputs)
 - Income – (labour/material + replacement cost of capital (FL-LRAIC))
 - Example: semiconductors need 45% gross profit margin for R&D
- Teece & Coleman: Even if economic profits are high, distinguish between
 - **Scarcity rents**: desirable since they invite investment in new sources
 - **Entrepreneurial rents**: desirable since they offer a ROI, and invite investment in innovation (US SCt in *Trinko*)
 - **Monopoly rents**: undesirable, since based on naked exercise of market power, especially exclusionary conduct without efficiency justifications
- Question is not “how high” economic profits are, but **“how long” in time**
 - If barriers to entry are substantial, economic profits are persistent
 - But reverse not true: persistence does not always indicate barriers to entry – can indicate an innovator who is and stays ahead of the curve

Interim Conclusion: In dynamic markets, innovation level (not market share) should create presumption

- Conclusion: Innovation is the key:
 - in dynamic markets, **persistence of high economic rents without innovation can be indicative of dominance**
 - Conversely, persistence of innovation by firm accused of dominance should create presumption of dynamically competitive environment
- Possible to rebut presumption by analysing barriers to entry / ability to exclude rivals (or deter/prevent entry or expansion) :
 - *“constraints imposed by the existing supplies from, and the position on the market of, actual competitors ...*
 - *constraints imposed by the credible threat of future expansion by actual competitors or entry by potential competitors,...*
 - *constraints imposed by the bargaining strength of ... customers”*

What Barriers to Entry give power over price?

- Guidelines: “*an undertaking can be deterred from increasing prices if expansion or entry is likely, timely and sufficient.*”
- High economic profits, high market shares and shortage of rival production capacity convey power only if there are Barriers to Entry:
 - Legal/regulatory barriers (statutory monopolies; import bans)
 - Constraints on access to inputs, raw materials, essential facilities
 - Unavoidable IPR (SEPs, where no design-arounds available)
 - Outlet constraints (clogged distribution networks; consumers locked up in long-term exclusive contracts; high switching costs)
 - Network effects (*Microsoft case*)
 - Dominance in neighbouring markets with associative links (*Tetra Pak*)
 - High product differentiation (“*brand image, product features, product quality, level of service or the location of the seller.*”)

What Barriers to Entry?

- If cost curves and prices are identical for different firms, no firm can earn long-term economic profit. Incumbents can earn a long-term profit only if new entrants face costs or barriers that incumbents do not or have not had to deal with and that are so high as to prevent entry.

Carlton, Perloff, *Modern Industrial Organization*, 2nd ed., p. 110.

- Focusing only on these true barriers to entry is consistent with *Guidance Paper* recognition that protecting competitors is not the objective of Article 102 and that **less efficient competitors may well be driven out of the market by legitimate behaviour**
 - Not merely economies of scale/scope (cf. *Bronner*)
 - Exclusive rights or franchises for the incumbent,
 - subsidies to incumbents that entrants do not receive,
 - Post-initial-entry regulation imposing special burdens on new entrants or limiting possibilities for the creation of alternative infrastructures,
 - network effects, new blocking patents, etc.

Disproving dominance

- Bidding markets:
 - where customers choose suppliers through tenders, especially where tenders are large and infrequent (“lumpy” demand), which creates strong incentives to bid aggressively, what matters is “*how many credible competitors actually participated as bidders and thus created competitive constraints.*” (Bombardier case)
- New or highly innovative markets:
 - Persistently high share may not indicate a lack of effective competition if the market is characterised by rapid innovation, as the market leader might be forced to continuously improve its products and processes to stay ahead of rivals. (Office of Fair Trading, *Assessment of Market Power*, OFT 415, December 2004, para. 11: Horizontal Guidelines para. 73)

Disproving dominance – countervailing power

- *“countervailing buying power may result from the customers’ size or their commercial significance for the dominant undertaking, and their ability to switch quickly to competing suppliers, to promote new entry or to vertically integrate, and to credibly threaten to do so.”* (Guidance paper para 18 n 1; Gottrup-Klim; Italian Flat Glass).
- Clear when the buyer can easily switch to alternative suppliers, sponsor new entry, or self-supply – *i.e.*, if there are low barriers to entry
- Also relevant: if the seller depends on buyer and has ability to retaliate.
- Guidelines: *“Buyer power may not, however, be considered a sufficiently effective constraint if it only ensures that a particular or limited segment of customers is shielded from the market power of the dominant undertaking.”*
 - That makes sense if the abuse includes exploiting/foreclosing powerless counterparties.
 - But not if the abuse is allegation of exploitation of the power buyer. Define separate market?



PART 2: Can there be “Dominance” in free
“cloud” services? The *Google* example

~25 (!) Complaints cover almost all aspects of Google's business

Search

- Demotions in search results
- Favoring Google's own "vertical" search results
- Giving search results away free
- Quoting snippets from rival sites in Google "vertical" search results

YouTube

- Favoring of YouTube in search results
- Access of rival search services to YouTube

Ads

- Demotions in ad results
- Manipulation of AdWords auctions
- Tying of ad and search results
- AdWords API restrictions

Distribution

- Search distribution deals with OEMs
- Exclusive search syndication deals (AFS)

What dominance in a free product?

- Complainants argue Google is dominant
- Most reviewers accept this based on anecdotal evidence or personal impressions
- Especially when “user data” are cited, suggesting that “90%+” of “searches” in the EEA is done on Google

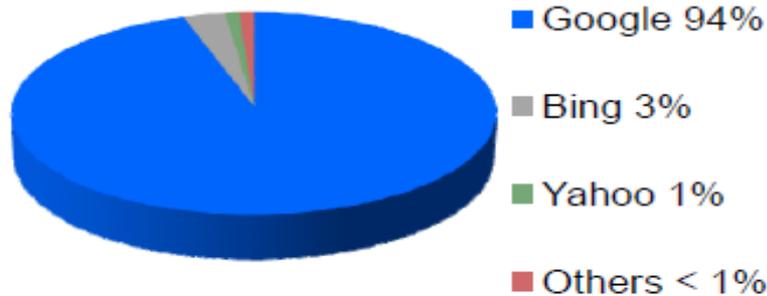
- Let’s test the new rules on dominance taking into account that
 - This is a free product – a two-sided market
 - The only trading relationship is with advertisers
 - Innovation is rampant

First question:

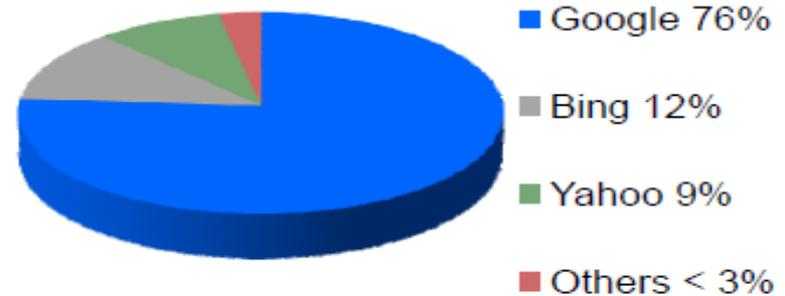
Is there power over consumers in free services?

- All complaints premised on notion that Google is “dominant” in “horizontal search” on the basis of its high usage shares

Europe



North America



- But **two issues**:

- This excludes new entrants – new means to find content (e.g. social networks), “vertical” sites (generate 40% of searches), and mobile apps
 - vertical search use CPA ads that command high profits. Leave low profit ads to Google
- These are usage shares of free services, not shares of sales

40% Of Searches Take Place On “Vertical” Sites (and this excludes searches via mobile apps)

Share of search queries:
general web search engines vs. specialized sites

Search on general
web search engines



63%

37%

Search on specialized
sites



comScore qSearch, U.S., January 2012

excludes Mobile apps !

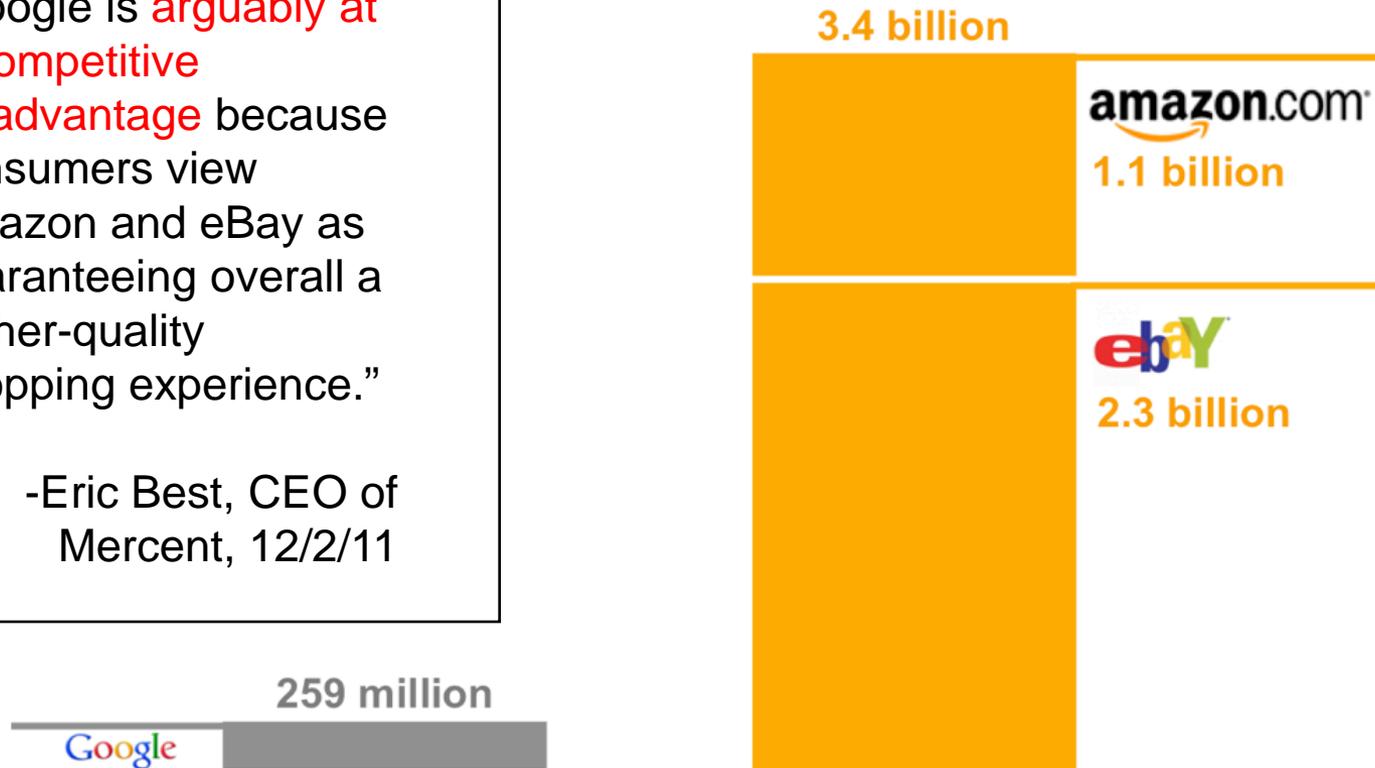
**Social networks, portals,
specialized search sites,
shopping sites, fora**

For product searches, consumers prefer specialized sites

Amazon and eBay combined handle **13 times**
more product searches than Google

“Google is **arguably at a competitive disadvantage** because consumers view Amazon and eBay as guaranteeing overall a higher-quality shopping experience.”

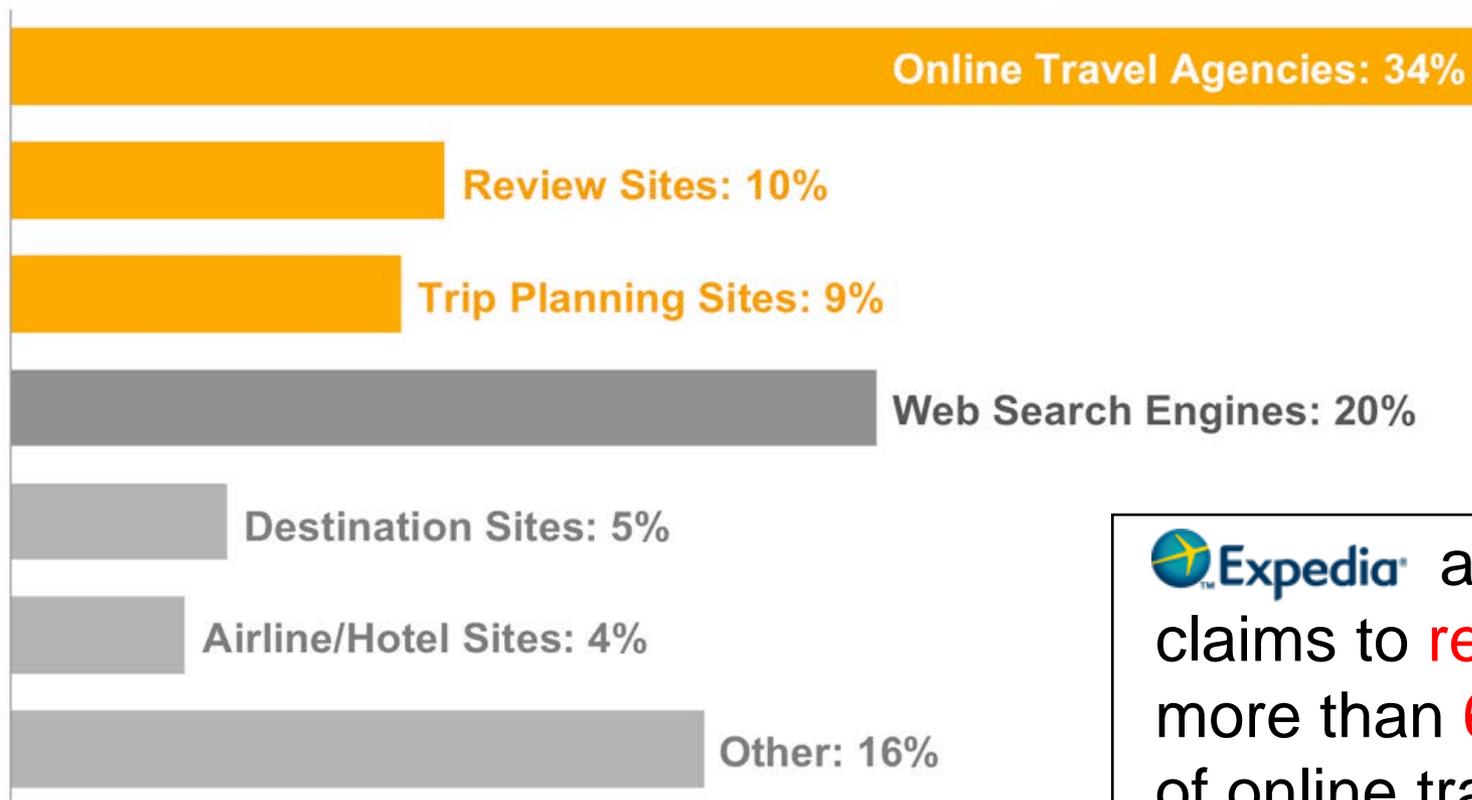
-Eric Best, CEO of
Mercent, 12/2/11



Source: comScore, number of product searches, October-December 2011

For travel search, users mostly use specialized sites

53% of U.S. adults primarily use specialized sites to conduct online travel research



 **Expedia** alone claims to reach more than **61%** of online travelers

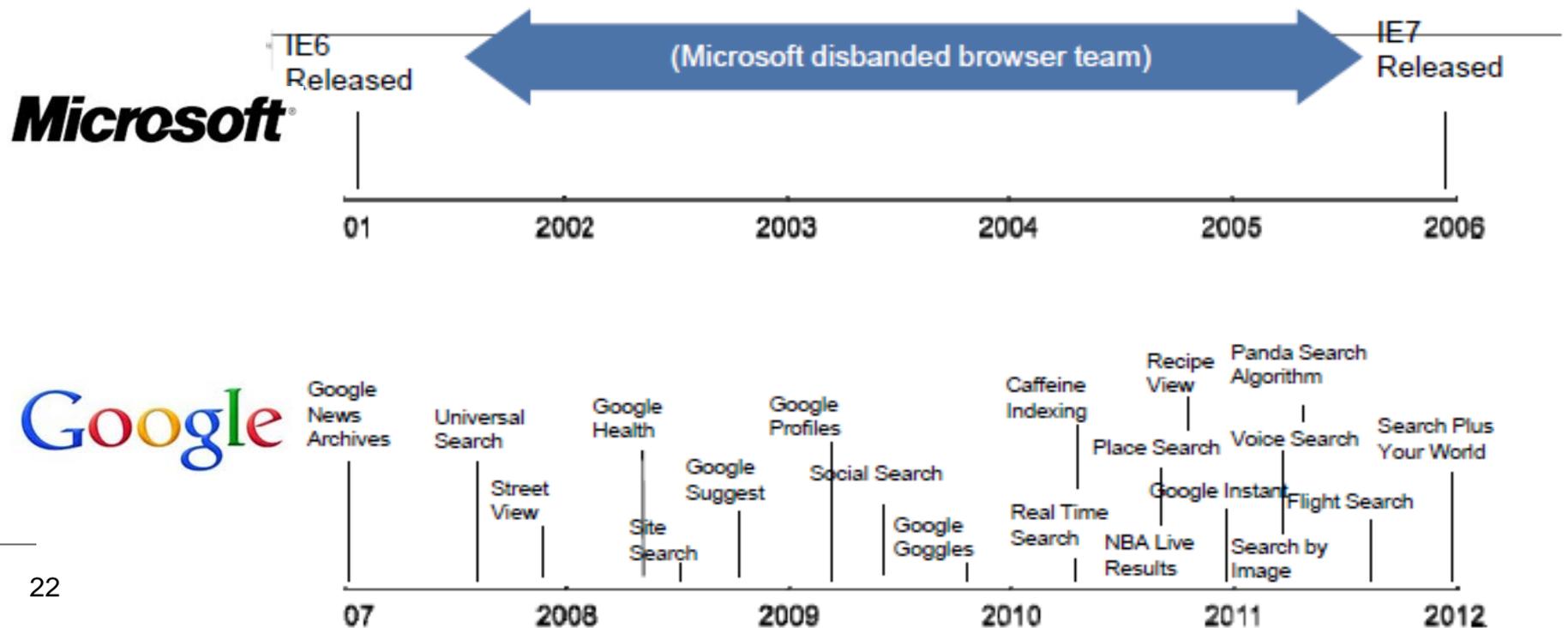
eMarketer: primary online source used by U.S. adults to research travel (Mondial Assistan

Guidance From EC and *Landgericht Hamburg*

- **EC in *Microsoft/Skype***: Combined share of 80-90% of online video calls, but usage share not good indication of competitive strength
 - **No power over price.** *“If a provider starts charging for a service which was used for a long time free of charge and there exist alternative services offered for free, it can be expected that consumers would immediately switch to these competing services”*
 - Why treat search different than online video calls?
- **Landgericht Hamburg in *Wetterdienstleister*** (April 11, 2013)
 - **Rivals include specialised search engines.** *“there are definitely some powerful competitors in this field, such as Twitter or Facebook, not to mention other – partly vertical – search engines”*
 - **No barriers to switching.** *“There are serious competitors to which the users could switch quickly, because search is free and there are no barriers to switching”*

2. If no power over price, does Google have power over quality / innovation?

- Lower quality means fewer users => less ad revenues
 - Significant incentive to keep quality high and innovate
- No evidence that rate of innovation is non-competitive
 - Contrast Browser case (2009):



Guidance From EC and *Landgericht Hamburg*

- *Microsoft/Skype*: For “free services”
 - **Innovation is critical.** Users would switch if “*innovation was stopped or slowed down*”
 - **Other factors.** No network effects, ease of switching, multi-homing,
- Landgericht Hamburg in *Wetterdienstleister*
 - **Constant need to provide optimal result.** “*There are serious competitors to which the users could switch quickly, because search is free and there are no barriers to switching*” ...“*Google must face this competition and must constantly strive to provide the optimal search result for the search engine user, i.e., give the user what he/she wants*”

Second question:

If no power over users, is there power over websites?

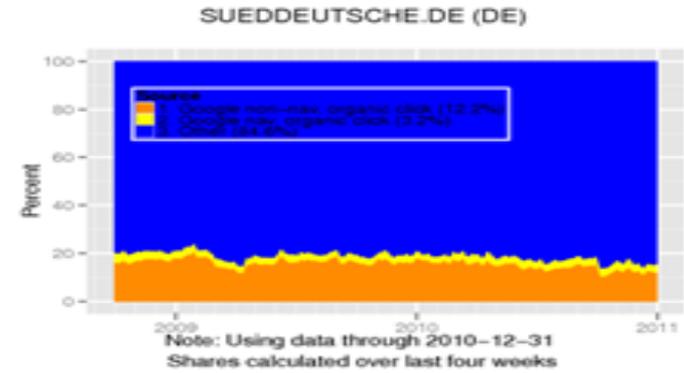
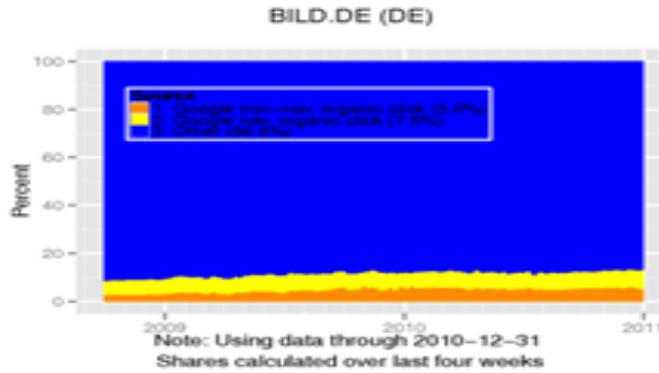
Websites have other ways to market their service

GoCompare
Etc.

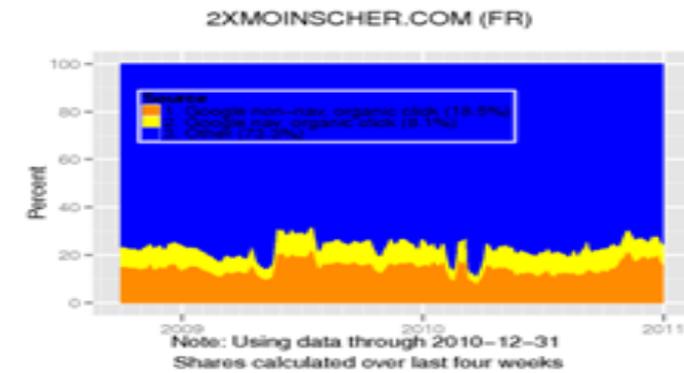
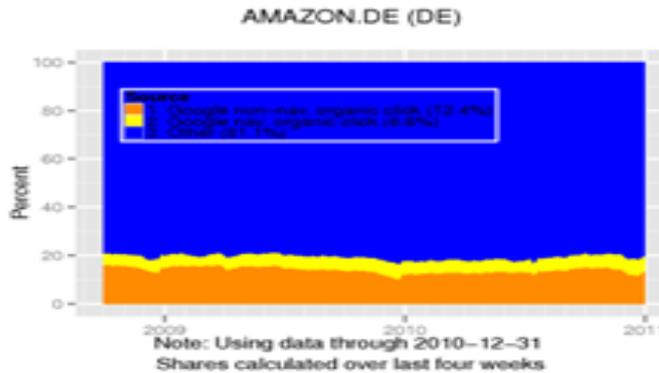
They can also use online ads and AdWords

Self-chosen dependency on free listing conveys no rights

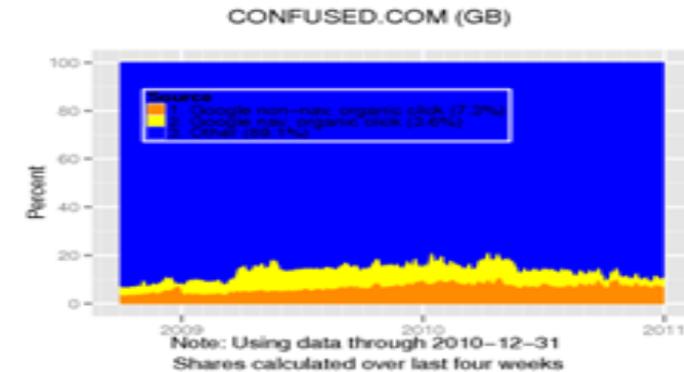
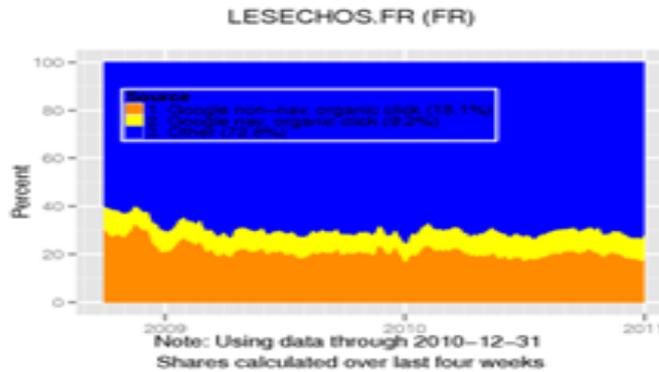
News



Shopping



Finance



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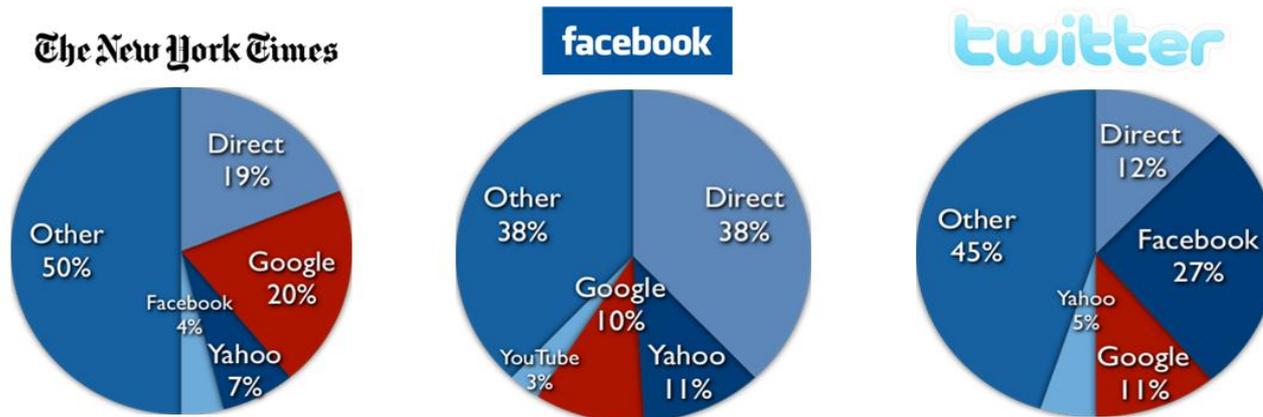
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Third question: If no power over users/websites, Is there power over advertisers?

- Is there competition between search ads, online ads, and offline ads?
 - In other words, can Google raise price for search ad space?
 - Hard to do, since ad space is auctioned off
- Complainants say online search ads are special: targeted
 - But many non-search ads are targeted too (like Facebook ads)
- And what matters is **Return on Investment / “Cost per Acquisition” (CPA)**
 - Advertisers compare CPA, and “multihome” (place ads in various media)
 - If search ads have 2x conversion of online ads, and price is 2x, CPA is still equal
 - Advertisers will switch **part** of their budget away to non-search ads if the CPA of search ads goes up compared to non-search ads
- Landgericht Hamburg in *Wetterdienstleister*: “it seems necessary to consider the area of online advertising for the determination of the relevant market” => Not just search ads

1. Is Google An Essential Facility?

- Are there “*technical, legal or economic obstacles capable of making it impossible, or even unreasonably difficult*” for websites to attract traffic otherwise (*Bronner*)
 - In fact, websites have various ways to attract visitors.
 - **If no essential facility, then “favouring” is no abuse**
 - Even essential facilities do not have to carry rivals for free



Complainants admit traffic comes from various sources

- **Expedia** CEO Dara Khrosrowshahi told investors that search traffic is *“much less profitable traffic”* than direct traffic
- **Yelp** co-founder and CEO Jeremy Stoppelman: *“On average, our mobile app was used on 7.2 million mobile devices per month in the second quarter, up 70 percent year-over-year,”* *“Approximately 40 percent of Yelp searches are now conducted on our mobile apps, becoming the majority on weekends”*
- **TripAdvisor** CEO Stephen Kaufer in a July earnings call: *“Google’s Google Places app is not taking traffic away from TripAdvisor”*
TripAdvisor is the second most popular Facebook app
comScore (8/12): TripAdvisor is the most popular travel website
- **Kayak** SEC filings: 75% of Kayak’s traffic comes through direct navigation. Only 10% came from search engines -- unchanged from November 2010, when Google entered travel in the U.S.

Conclusion: Dominance?

- Existing case law on dominance does not fit “free products”
 - In multi-sided markets, where service is supplied to get users’ attention to sell ads, key question: power in supply of ad space
 - 1. Charging for free service => users switch away, causing ad revenue loss
 - 2. Lower quality of search results – by excluding links to good websites – causes users to switch, causing ad revenue loss
 - 3. Raising prices for search ad space above alternatives causes advertisers to switch part of their budget to other ad media => no Google dominance?
No final finding: Art 9 settlement relies on “Preliminary Assessment”
- Dominance is ability to reap high economic profits for long duration without entry or innovation.
 - in dynamic markets, **persistence of high economic rents without innovation can be indicative of dominance**
 - Conversely, persistent innovation by firm accused of dominance should create presumption of dynamically competitive environment

Conclusion: Art 9 decisions

- Reason for settlement in EU is practical, and peculiar to EU context
- The EC process in large cases is essentially political
 - Slow, risk of high fines (*Intel, etc*); opportunistic follow-on damage claims
 - Confirmation bias (investigator = prosecutor = judge = executioner)
 - Inadequate judicial review by GC and CJEU of prohibition decisions
- Art 9 “Commitment Decision” (settlement) offers a solution for defendants
 - Relative fast solution necessary in fast-moving markets
 - No fines, no findings of dominance or abuse; no precedent or findings of law
 - Courts must review follow-on damage claims on the merits *ab initio*
 - Relatively difficult for complainants to appeal (*Alrosa*)
- But:
 - No precedent value. What does Facebook learn from this case?
 - Risk of “administrative hold-up”
 - Not a precedent in court or national authorities: still have to prove facts / law

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