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HEARING ON DISRUPTIVE INNOVATION

-- Note by BIAC --

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More documents related to this discussion can be found at www.oecd.org/daf/competition/disruptive-innovations-and-competition.htm

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BIAC

1. BIAC welcomes the opportunity to provide its views to the OECD Competition Committee regarding disruptive innovation. Competition policy response to new technologies or business models that disrupt existing industries is a key concern to the business community comprising both incumbent industries and new entrants.

1. Introduction

2. Disruptive innovations come about when companies pursue business models of providing simpler, cheaper, or more convenient products, processes or delivery methods, and where this pursuit drastically redefines performance along parameters such as accessibility, simplicity, convenience, or user-friendliness. Disruptive innovation leads to the displacement of existing technologies and business models and creates new markets and value networks.¹

3. Disruptive innovations are often associated with internet-based services, such as Netflix transforming the market for home rental videos, Uber disrupting the taxi business, Amazon replacing traditional brick and mortar shops, Air BnB changing the hotel market and Booking.com disrupting the traditional hotel reservation market. However, the concept of disruptive innovation is not a “new” phenomenon: steamboats replaced sailing ships, telephony replaced telegraphy and LED lighting is displacing traditional incandescent lighting. Nonetheless, nowadays many disruptive innovations rely on the digitization of the economy and are, increasingly, platform-based. Platforms first appeared for the diffusion of content, but are now also present in other sectors, such as banking (payment platforms) and distribution (market places).

4. The importance of innovation, and of disruptive innovation in particular, for economic growth, is undisputed. Accordingly, BIAC takes the firm view that the regulatory environment and antitrust policy should be squarely attuned to innovation, should accommodate novel business models, and should create and stimulate innovation incentives. First and foremost, competition law must be applied in a normative and effective manner to curtail and deter anti-competitive activities by existing market players that may collaborate on, discuss and try to implement collective actions to try to block existing competitors from bringing innovations into the market, which innovations would be for the potential benefit of consumers and other users. Competition law should protect competitive choice especially where dynamic change may enhance consumer welfare. However, BIAC notes that the analytical framework that is commonly used to identify pro-and anti-competitive business conduct is in a number of respects not conducive to a proper evaluation of business transactions. In particular, the tools of traditional price effects analysis are not ideally suited to the proper analysis of innovation-related business transactions. Below, BIAC will suggest a number of avenues that competition law agencies may - and should - explore to more fully evaluate innovation-related business conduct, without necessarily detracting from the premise that market participants are best served by predictable rules that are firmly rooted in economics.

5. BIAC also notes that in a number of cases innovative business concepts are hindered by existing regulations that have been adopted to regulate existing or “old” markets. Prime examples include Uber, which has the potential to transform the taxi business, and Air BnB, which currently

¹ See Bower and Christensen, Disruptive Technologies: Catching the Wave, Harvard Business Review, Jan - Feb 1995, at 43-53.

makes inroads on the hotel market. While BIAC appreciates that existing regulation may serve legitimate interests, including environmental, health and safety², employment and consumer protection requirements, it also believes that the economy will benefit from a critical, unbiased and regular review of existing regulations to ensure that their purpose is understood and that they are transparent³ and no more restrictive than necessary to achieve that purpose.⁴ This is vital, particularly if existing regulated businesses are threatened by new, innovative entrants that may be hindered by those regulations or the regulations have the effect of limiting the ability of existing businesses to react to and compete with the new entrants. BIAC takes the position that competition law enforcement agencies are ideally situated to play a key role in that respect. As a result, BIAC supports initiatives to enhance the role of competition agencies in the legislative process, for instance by imposing instructions on governments to involve competition agencies in the review of draft legislation to evaluate its impact and to enable competition agencies to challenge and propose review of existing outdated regulations. The competitiveness of markets and the scope for innovative business concepts should be a key parameter in such reviews. In addition, competition agencies with jurisdiction to review unfair competition have a particular responsibility to ensure that regulations are enforced reasonably and so as to minimize their restrictive effects on competition⁵.

2. Why is traditional competition law ill-suited to deal with disruptive innovation?

6. It is clear that innovation is a key driver for economic growth and societal welfare. New products and services and improved production methods may on balance produce more consumer benefits than price decreases of existing products. However, competition law and policy first and foremost target cartels, market allocation and other static market inefficiencies. This emphasis on static price effects resulting from business transactions - either as a result of cartel agreements or monopoly pricing - and the relatively poor attention to effects on innovation has often been noted and criticized.⁶

² There is a societal requirement to achieve the appropriate balance between safety regulations and accepting risks by fostering innovation in new technologies. Advanced research and application in nanotechnology and biotechnology, for example, has triggered a controversial debate about the uncertainties of these technologies. There are concerns surrounding the ability to control certain disruptive technologies and the possibility of negative impacts on the ecosystem. See: European Commission, DG Enterprise and Industry (2012). *Disruptive Innovation: Implications for Competitiveness and Innovation Policy*. In: INNO-Grips, *Global Review of Innovation Policy Studies*. Prepared by Empirica GmbH. pp. 43-44.

³ An interesting example of an initiative to improve transparency and assist innovators is the UK Financial Conduct Authority's Innovation Hub designed to help innovators navigate regulation and to identify where changes to regulation are needed to encourage innovation - see www.fca.org.uk/news/speeches/the-fca-and-innovation.

⁴ An example of potentially unduly restrictive regulation is the restriction, imposed by many jurisdictions around the world, on the number of taxi licences granted. Such regulation risks creating an artificial scarcity and also risks posing an undue barrier to new, potentially disruptive entrants.

⁵ An example of potentially excessively broad sanctions would be the withdrawal of telecommunications and payment services to Uber in Spain, resulting in Spanish consumers being unable to use the app even when travelling in countries where it is lawful.

⁶ See among the many contributions for example Hovenkamp, *Signposts of Anticompetitive Exclusion: Restraints on Innovation and Economies of Scale*, 2006 Fordham, Competition L. Institute, 409-31 (B. Hawk ed.) (2007), also noting that “*[t]he often underappreciated corollary of Schumpeter’s and Salow’s work is that, because innovation is such an important engine of economic growth, restraints on innovation very like cause considerable greater social harm, than restraints on price. Such restraints may be more harmful even than cartels, but they are almost certainly more harmful than the price effects of exclusionary practices.*” See also Lugard, *Innovation in the domain of EU competition law enforcement. Blowing in the wind?*, European Competition Law Annual 2014: Effective & Legitimate Enforcement of EU Competition Law (Lowe, Marquis, Eds). Graef et al draw

7. Considering the importance of innovation, one would expect that competition agencies have over time developed a clear framework as to how innovation should be incorporated in the assessment of business transactions. Logically, such a framework would apply both when innovation might result in efficiencies, as well as the transaction in question might have innovation-limiting effects. However, this is not the case.

8. The lack of a clearly articulated analytical framework is due to at least four factors.

9. First, it is difficult to predict when innovation will occur in a specific market or transaction context. Indeed, from an ex post perspective, one can easily conclude that the gains from innovation are considerable, but ex ante, it is often difficult to predict which new business models and innovative initiatives will succeed and how much consumer benefits they will generate. Equally, innovation can cut across several markets at once, making it difficult to locate its likely competitive impact.⁷

10. Second, the models upon which competition law typically relies focus on the relationship between price and marginal cost. And because the conditions under antitrust and merger control rules applying to dynamic efficiencies are generally strict,⁸ there are few precedents which could form the basis for a comprehensive analytical framework that gives fuller consideration to innovation.

11. Third, it can be assumed that a number of business transactions that involve disruptive innovation remain unnoticed by competition agencies as they do not meet the relevant thresholds for review.

12. Fourth, at least in part, competition enforcement agencies' perception of innovation is shaped by the specific cases with which they are confronted.⁹ Typically, enforcement agencies deal with these cases in a reactive manner: indeed, most cases that potentially involve innovation-related features consist of merger filings and complaints under exclusionary conduct rules. However, many of these cases do not require an in-depth analysis of the specific innovation efforts of companies. This may in turn limit the agencies' ability to develop a generally applicable approach and vision of how innovation should be factored into the analysis.

13. It is plausible that as a corollary of this reactive approach competition agencies tend to perceive innovation as a phenomenon originating from within companies' existing business models and "value networks", and emphasize the current ecosystems and markets in which companies operate. However, this narrow vision of innovation is not reflected in economic literature.

14. Indeed, economic research makes clear that the possible sources of innovation are diverse. For instance, a number of authors take the view that it is wrong to exclusively concentrate on

attention to the use of the notion of 'competition in innovation' in the EU's approach to Article 101 TFEU but to its absence from merger review guidance. See Graef, Inge, Wahyuningtyas, Shi Yuliana;Valcke, Peggy (2014), How Google and Others upset competition analysis: disruptive innovation and European Competition law, 25th European Regional Conference of the International Telecommunications Society (ITS) 22-25 June 2014.

⁷ See for example Halverson, James, Telpner and Brian, Innovation and Potential Competition in Rapidly-Changing High-Tech Industries (2014).

⁸ Graef et al suggest that the conditions may be impossible to meet in cases involving disruptive innovation. See note 6 above.

⁹ And the time when they are confronted with them. For example, the UK Competition Commission's investigation into movies on pay TV recognised that streaming services such as Netflix and Lovefilm (amongst other developments) had between the issue of its provisional findings and its second provisional findings increased consumer choice such as to remove the earlier adverse effect on competition. An investigation just a few months earlier would presumably have stood with the earlier incorrect assessment - <http://www.competition-commission.org.uk/our-work/directory-of-all-inquiries/movies-on-pay-tv-market-investigation/analysis>.

individual companies as the originators of innovation, but also attach importance to the factors linked to the commercial and economic environment that form the basis of innovation.¹⁰ They point out that, in some cases, innovation builds on earlier inventions (cumulative innovation),¹¹ while in other cases innovation results from interaction between companies and users of services and products (user-driven innovation)¹² or is a result of cooperation with other organizations (open innovation).¹³

15. Economic literature also distinguishes between “sustaining innovation” on the one hand and “breakthrough”, “radical” and “disruptive innovation” on the other hand. Sustaining innovation does not generate new markets or “value networks”, but is aimed at enhancing existing products and services. In contrast, “breakthrough” or “radical” innovation has the potential to disrupt existing markets and to create new ones.

16. It appears that in the few cases where antitrust agencies are required to address markets where innovation plays a role, their emphasis is on existing platforms and value networks and, as a consequence, on sustaining innovation, as opposed to disruptive innovation. Indeed, some of the most prominent exclusionary conduct cases in Europe, Microsoft, and Intel, related to existing platforms and value networks of the relevant dominant companies and particularly concerned sustaining innovation. In the Microsoft case, the European Commission attempted to safeguard competition from Sun and Novell (in the area of operating systems) and of RealNetworks (in the market of media players) while in Intel the Commission aimed to secure competition between Intel and AMD in the market for CPUs for personal computers.

17. In the meantime, it has however become clear that the arrival of disruptive innovation in the form of the internet and internet-based services have significantly reduced the significance and importance of Microsoft’s operating system. The same applies to Intel’s market position on the market for CPUs for desktops; the trends of tablets and smartphones has created room for CPU manufacturers such as ARM and Qualcomm.

18. For the application of competition law, it is first important to acknowledge that - as confirmed by economic research- disruptive innovation can take many different guises: from innovative pricing structures to new (on-line) distribution methods to entirely new services and functionalities valued by consumers. Second, while incumbents may introduce disruptive innovations, often innovations come from non-established players that are less constrained in designing and implementing new technologies and business models.¹⁴ Significantly, those non-established firms may be active on markets that are far away from the markets that will eventually be disrupted by their innovations. In order to determine the competitive effects as accurately as possible, sound competition law enforcement should take account of the various guises of potentially disruptive innovation, as well as the possible sources of disruption.

19. Over-reliance on short-term price competition prevents competition enforcement agencies from taking account of more important competitive dynamics, often originating from outside conventional antitrust markets, that may challenge and disrupt existing markets and eco-systems.

¹⁰ See Govindarajan and Trimble, “Organizational DNA for Strategic Innovation”, California Management Review 2005, Volume 47, no. 3.

¹¹ See Scotchmer, Innovation and Incentives, MIT Press 2004.

¹² See Von Hippel, The Sources of Innovation, Oxford: Oxford University Press 1988.

¹³ See also Miller and Côté, The Faces of Innovation, 2008, <http://papers.ssrn/sol3/papers.cfm?abstract_id=1106740>.

¹⁴ See for instance K. Jhaveri, Disruptive Equilibrium: Antitrust for an Innovation Economy and J. Utterback, The Dynamics of Innovation.

20. The observation that short term price competition analysis may not be sufficient to properly identify the competitive effects in a given matter, has two main practical consequences. First, applying traditional market definition analyses, such as the SSNIP test, may lead to overly narrow markets and may ignore the competitive pressure coming from disruptive products and services from outside the relevant markets¹⁵. And second and relatedly, conventional unilateral effects analysis, which typically concentrates on closeness of competition, may easily fail to capture the competitive pressure from companies that may not be the closest competitors, but who nevertheless have the potential to exert significant competitive constraints by offering innovative offerings.¹⁶

3. What can be done to make competition law enforcement more receptive to disruptive innovation?

21. BIAC believes that there is a priori no need for specific or sector specific regulation to properly deal with the analysis of the competitive effects of business transactions involving disruptive innovation and that existing competition law tools, if properly applied, may suffice. However, competition law enforcement can be made more receptive to disruptive innovation.

22. First, competition enforcement agencies should more explicitly evaluate whether business transactions are likely to have the effect of (i) spurring (disruptive) innovation, or (ii) dampen or diminish the parties' incentives to bring a disruptive business model to the market.

23. Acquisitions and other (non-) structural transactions may first provide the investments, resources and customer base for a disruptive business model to come to fruition and achieve adequate scale. High shares in newly established and rapidly evolving markets may not be indicative of market power.

24. On the other hand, disruptive innovation may be dampened or halted through the acquisition by an incumbent firm of a potentially disruptive business model where the acquiring company has the ability and incentive to protect existing business models. Alternatively, tying up key customers may deny a disruptive new entrant sufficient scale to gain a foothold in the market. BIAC acknowledges that these scenarios may theoretically occur and produce negative welfare effects, but stresses that decisions to intervene against potentially innovation-limiting conduct should be based on sound economics and a robust theory of harm.

25. Second, competition agencies should develop a more comprehensive analytical framework of innovation that takes account of the various possible sources of competition and their potential importance in terms of possible welfare gains.

26. Third, competition agencies can further develop their insights into the ways that innovation may be hampered, for instance by new research into double-sided markets.

27. Fourth, competition agencies should consider re-evaluating the relative importance that is attached to restraints on follow-on innovation versus restraints on disruptive innovation. While both types of innovation may produce significant welfare gains, BIAC is of the opinion that in many cases competition agencies are more readily inclined to intervene against restraints on follow-on innovation, without necessarily weighing the benefits of earlier, disruptive innovations.

28. Fifth, competition agencies should more clearly acknowledge that the traditional tools of merger control and antitrust analysis, in particular the SSNIP-test, may not be able to adequately define the relevant markets that may be affected by disruptive innovation and should reflect on

¹⁵ As nearly happened in the Movies on Pay TV investigation in the UK. See note 8 above.

¹⁶ The corollary of this observation is that market shares may have limited informative value only. For a recent EU example, where the European Commission acknowledged this, see Case M.6281 - Microsoft / Skype.

alternative ways to identify and quantify the likely effects of possibly disruptive innovation on existing markets. By the same token, the analysis of competitive effects, particularly closeness of competition analyses may fail to identify the effects of disruptive innovation.

29. Sixth, competition agencies may reflect on the question whether the scope of competition and merger control law is adequately defined with a view to allowing agencies to intervene in cases involving disruptive innovation. A legitimate question in this respect is whether current merger control rules capture business transactions involving potentially disruptive innovation business models with as yet little or no revenues. However, BIAC strongly cautions against the use of vague, low or ill-defined thresholds and powers to intervene below set thresholds and stresses the importance of clear local nexus requirements. In this context it is worth mentioning that the German monopolies Commission calls for a “size of transaction” test on EU and national level.¹⁷

30. Seventh, competition agencies may consider the use of interim measures to safeguard competition in fast-moving markets. This could be particularly relevant in markets where network effects are important.¹⁸

4. Which other measures should be considered beyond the mere enforcement of competition law?

31. BIAC observes that potentially disruptive business models may fail to reach the market as a result of government regulation and that in many cases public restraints can be more harmful than private restraints on competition and innovation. BIAC is convinced that much can be done to ensure that existing regulation is regularly reviewed and, if appropriate, amended, to take account of new, innovative ways of doing business to the benefit of established and new competitors. Despite the fact that the evaluation of (disruptive) innovation by competition agencies can be improved, those same agencies can play a very valuable role by identifying those instances and markets where public regulation hinders dynamic competition and innovation, for instance by subjecting new or established business models to overly strict regulatory requirements, and suggest ways to amend existing regulation.

32. The Canadian competition authority has played just such a role. In its new publication entitled *The Advocate*, the Canadian Competition Bureau has advocated the view that innovative business models have the potential to offer important benefits to consumers through more competition, including lower prices, greater convenience and better service quality.¹⁹ As well, pursuant to his statutory mandate, which includes advocacy before tribunals, the Commissioner of Competition made recommendations to the City of Toronto Taxicab Industry Review that any new regulations applied to new service methods and technologies in the taxi industry be designed to allow entry and competition.²⁰

33. The role of competition agencies in relation to regulation that optimally accommodates innovation could either be mandatory, for instance by creating obligations to procure competition agencies’ views on new or existing legislation, or be of an advisory nature. BIAC would be in favour of a flexible, but nonetheless robust mandate for competition agencies in this respect.

¹⁷ See Special Report 68: Competition Policy: The Challenge of digital markets, Monopolkommission, http://www.monopolkommission.de/images/PDF/SG/SG68/S68_summary.pdf

¹⁸ Direct or indirect network effects are in some instances conducive to firms with large market shares. In these markets, it is all the more important to ensure that markets remain contestable.

¹⁹ Competition Bureau of Canada. Taxi industry’s emerging digital dispatch services. *The Competition Advocate*. (Gatineau, Q.C.: Competition Bureau, November 25, 2014), available at: <http://www.competitionbureau.gc.ca/eic/site/cb-bc.nsf/eng/03842.html>

²⁰ Competition Bureau of Canada. *Submission by the Commissioner of Competition to the City of Toronto Taxicab Industry Review*. (Gatineau, Q.C.: February 18, 2014), available at: <http://www.competitionbureau.gc.ca/eic/site/cb-bc.nsf/eng/03667.html>