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DAF/COMP/GF/WD(2015)45

Organisation de Coopération et de Développement Économiques  
Organisation for Economic Co-operation and Development

21-Oct-2015

English - Or. English

**DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS  
COMPETITION COMMITTEE**

## **Global Forum on Competition**

### **THE IMPACT OF DISRUPTIVE INNOVATIONS ON COMPETITION LAW ENFORCEMENT**

**Contribution from the Business and Industry Advisory Committee (BIAC)**

**-- SESSION III --**

*This contribution is submitted by BIAC under Session III of the Global Forum on Competition to be held on 29-30 October 2015.*

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**JT03384639**

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**THE IMPACT OF DISRUPTIVE INNOVATIONS ON COMPETITION LAW ENFORCEMENT -  
SUMMARY OF DISCUSSION POINTS**

**-- BIAC --**

BIAC welcomes the opportunity to provide its views to the Global Forum on the phenomenon of disruptive innovation and, in particular, the questions and challenges it raises for competition law enforcement. Competition policy responses 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.

This submission concentrates on the theme of Session III, i.e. the challenges that may arise for competition law enforcement in the context of disruptive innovation.<sup>1</sup>

**1. Introduction**

1. 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.<sup>2</sup>

2. While the concept of disruptive innovation is not limited to “new” technologies, 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. Increasingly, disruptive innovations are 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).

3. 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, accommodate novel business models, and create and stimulate innovation incentives. However, it 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 innovation-related business transactions. In particular, the tools of traditional price effects analysis limit

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<sup>1</sup> BIAC respectfully refers to its submission for the Hearing on disruptive innovation organized by WP 3 on 16 June 2015, which already included a number of observations and recommendations regarding competition law enforcement in relation to disruptive innovation. This submission draws and expands on BIAC’s 16 June submission

<sup>2</sup> See Bower and Christensen, Disruptive Technologies: Catching the Wave, Harvard Business Review, Jan - Feb 1995, at 43-53.

the proper analysis of these transactions. Below, BIAC will suggest a number of avenues that competition law agencies may - and should - explore to more fully appreciate 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.

4. In a number of cases innovative business concepts are hindered by existing regulations that have been adopted to regulate existing or “old” markets. This topic will not be discussed in the present paper.<sup>3</sup>

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

5. 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 limited attention to effects on innovation has often been noted and criticized.<sup>4</sup>

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

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

8. First, it is difficult to predict whether 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 benefit they will generate.

9. Second, the models that competition law typically relies on focus on the relationship between price and marginal cost, while many disruptive innovations are platform-based providing zero-priced services in exchange of data, time or engagement of their users. And because the conditions under antitrust and merger control rules applying to dynamic efficiencies are generally strict, there are only few precedents which could form the basis for a comprehensive analytical framework that gives fuller consideration to innovation.

10. 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.

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<sup>3</sup> See further on this issue BIAC’s submission to the June 2015 meeting of WP3 of the OECD Competition Committee.

<sup>4</sup> 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).

11. Fourth, at least in part, the perception of innovation of competition enforcement agencies is shaped by the specific cases that they are confronted with. 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.

12. 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.

13. 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 concentrate exclusively on 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.<sup>5</sup> They point out that, in some cases, innovation builds on earlier inventions (cumulative innovation),<sup>6</sup> while in other cases innovation results from interaction between companies and users of services and products (user-driven innovation)<sup>7</sup> or is a result of cooperation with other organizations (open innovation).<sup>8</sup>

14. 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.

15. 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 concern sustaining innovation. In the Microsoft case, the European Commission attempted to safeguard competition from Sun and Novell (in the area of operation 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.

16. In the meantime, it has however become clear that the arrival of disruptive innovation in the form of the internet and Google's internet search technology has 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. Similarly, the development by Uber of a smartphone app connecting consumers and Uber drivers who are in the general vicinity, has reduced reliance on traditional business models in many major cities globally.

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<sup>5</sup> See Govindarajan and Trimble, "Organizational DNA for Strategic Innovation", *California Management Review* 2005, Volume 47, no. 3.

<sup>6</sup> See Scotchmer, *Innovation and Incentives*, MIT Press 2004.

<sup>7</sup> See Von Hippel, *The Sources of Innovation*, Oxford: Oxford University Press 1988.

<sup>8</sup> See also Miller and Côté, *The Faces of Innovation*, 2008, <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1106740](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1106740)>.

17. 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 that consumers value. Second, while incumbents may introduce disruptive innovations, often those innovations come from non-established players that are less constrained in designing and implementing new technologies and business models.<sup>9</sup> 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.

18. 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.

19. 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 markets; moreover, SSNIP test is very difficult, if not impossible, to apply when dealing with zero-priced services that may occur in platforms based business models. 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 pressure by offering innovative offerings.<sup>10</sup>

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

20. 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.

21. Acquisitions and other (non-) structural transactions may first provide the investments, resources and customer base for a disruptive business model to come to fruition.

22. On the other hand, disruptive innovation may for example 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 of sufficient scale to gain a foothold in the market. BIAC acknowledges that these scenarios may occur and that they may 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.

23. 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.

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<sup>9</sup> See for instance K. Jhaveri, *Disruptive Equilibrium: Antitrust for an Innovation Economy*, and J. Utterback, *The Dynamics of Innovation*.

<sup>10</sup> 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.

24. Third, competition agencies can further develop their insights into the ways that innovation may be hampered, for instance by new research into double-sided market, including the relationship between the two sides of the markets and network effects. ,

25. 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.

26. 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 alternative ways to define markets and to identify and quantify the likely effects of possibly disruptive innovation on existing markets. The geographic dimension of the market may also be difficult to define when disruptive innovators provide their services online. By the same token, the analysis of competitive effects, particularly closeness of competition analyses may fail to identify the effects of disruptive innovation. The assessment of market power, based on structural and static factors, is also difficult to apply to innovative markets where other dynamic tools may be more appropriate.

27. Six, 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 or ill-defined thresholds and widely defined power to intervene below set thresholds.

#### **4. Which other measures should be considered as complements to enforcement of competition law?**

28. 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.

29. 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 business models to overly strict regulatory requirements, and suggest ways to amend existing regulation. There are many examples of competition agencies engaging in this advocacy role. For instance, the Canadian Competition Bureau has advocated that innovative business models have the potential to offer benefits to consumers through more competition, including lower prices, greater convenience and better service quality. Specifically, the Canadian Commissioner of Competition, John Pecman, has 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.<sup>11</sup>

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<sup>11</sup> Competition Bureau of Canada. *Submission by the Commissioner of Competition to the City of Toronto Taxicab Industry Review*. (Gatineau, Q.C.: February 18, 2014). online: <http://www.competitionbureau.gc.ca/eic/site/cb-bc.nsf/eng/03667.html>

30. 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.