THE LIMITS ON LEVERAGING

Preserving innovation and customer choice whilst preventing the abuse of market power

2022

frontier economics

WWW.FRONTIER-ECONOMICS.COM

BERLIN | BRUSSELS | COLOGNE | DUBLIN | LONDON | MADRID | PARIS frontier economics

THE LIMITS ON LEVERAGING

Preserving innovation and customer choice whilst preventing the abuse of market power

February 2022

INTRODUCTION

The UK Government plans to legislate to give new regulatory powers to the CMA's Digital Markets Unit (DMU). The proposals respond to "a growing international consensus that the concentration of power in a handful of the largest digital companies is crowding out competition by erecting barriers to entry for other firms", whilst at the same time "making sure regulation is not overly burdensome and supports responsible innovation". A key part of the reforms is measures to prevent anti-competitive leveraging, where a firm uses its strong position in one market to exclude rivals in another market. The reforms contain several proposals aimed at addressing this concern.

We believe that one of the proposals being considered expands the scope of regulation too far and would run counter to the policy's overall objective to support digital innovation. The proposal in question requires large digital firms with Strategic Market Status (SMS) to "*not […] make changes to **non-designated activities** that further entrench the firm's position in its designated activity/ activities unless the change can be shown to benefit users".* (See principle 2(e)). **This proposal limits a firm's ability to operate even in areas where they have no market power whatsoever.**

This proposal risks making the UK a less attractive place to launch and experiment with new and better products:

- It throws the net of regulation over a wide range of pro-competitive innovation that benefits UK consumers, and puts those well-recognised benefits at risk.
- It could stop innovation, entry or improvement anywhere in a firm's product range, unless and until it approached the DMU for approval. It creates a model where firms have to seek permission to innovate.

EXEC SUMMARY

The UK government is legislating for new powers to regulate large digital firms.

One proposal includes plans to stop the introduction of all new and improved services within a large firm's ecosystem – unless and until the firm gets approval from the new digital regulator.

This puts lots of beneficial innovation activity at risk, in areas where large digital firms have no market power and are having a pro-competitive impact.

Blanket regulation isn't needed. Leveraging from one market into another only harms competition under specific circumstances – it makes sense for regulators to target their efforts on those cases.

The UK is currently an attractive place to launch and experiment with digital innovation. Regulation should ensure that these incentives are preserved.

- Placing the burden on large firms to demonstrate user benefits to the DMU ex ante is disproportionate. It presumes innovation is problematic until proven otherwise, rather than supporting innovation until a problem is proven to exist. This could prevent UK consumers from accessing new products and services.
- It risks jeopardising the UK's reputation as a pro-innovation economy. It creates a higher regulatory burden on innovation than has historically existed in the EU or beyond.

The large digital firms that may fall under the scope of the new regime play a key role in innovation. The government's own study on innovation in digital markets notes that these firms "have delivered exceptional breakthrough and disruptive innovations which have improved consumers' lives, created thousands of jobs for employees and…have intensified competition and increased consumer welfare".

Regulating to require permission for all of this activity cannot be the right approach. The fact that a firm offers new and better products in a market that is not working for consumers, or where the new firm faces strong competition, is unlikely to be a problem. Legislation should instead ensure that the DMU takes a more targeted approach, and focuses its efforts on identifying those cases where leveraging might raise genuine concerns.

Below we explore in more detail why the current proposal to regulate non-designated activities puts innovation, UK consumers and the UK economy at risk. Section 2 first explains what leveraging is, and the limited circumstances in which it can lead to competition concerns. Section 3 then sets out how leveraging can lead to greater innovation and competition in the market. Section 4 explains how the DMU proposals put those significant benefits at risk.

2 WHAT IS LEVERAGING, AND WHEN IS IT A CONCERN?

Despite the prevalent negative connotations, leveraging is a neutral term that simply refers to a firm that is active in one area expanding to launch products or services in a new area. Leveraging is everywhere in the economy because there are often benefits in offering customers more than one service, such as lower costs or better convenience. There are many examples of large firms leveraging, innovating and expanding into adjacent markets. For example:

- Tesco started as a pure market grocer, before expanding into a supermarket format. It later started selling household goods and health and beauty products, as well as petrol, clothing, home goods and electricals. New store formats and delivery channels were developed. Adjacent markets were created and entered (and exited) through Tesco Bank, Mobile and Blinkbox, while other geographies were entered (and exited) in Europe and Asia.
- Whitbread was founded as a brewery, before it moved into pubs and hospitality. Its brands Premier Inn and Costa Coffee were formed over time, as well as other restaurant chains. While many of its operations have been sold off, Whitbread's operations look very different today than at its inception, with the majority of its earnings coming from its hotel chain.
- BT similarly has evolved from providing landline services to providing mobile, broadband and television services, improving choice and outcomes for consumers.

The government has noted that leveraging can lead to competition concerns, such as the foreclosure of rivals, which, in turn, can lead to higher prices and lower quality. Several competition investigations in the digital space have focused on concerns related to leveraging. However, such concerns arise only in specific cases, when leveraging leads to an abuse of market power. Harm to competition doesn't automatically arise when leveraging happens, but rather in specific circumstances where:

- a firm has the ability to influence the competitive conditions – this means having **market power**;
- there is necessarily **a strong link** between the two markets, which means that influence in one market counts on the other;
- it must be possible to use that linkage to unfairly **disadvantage rivals**; and
- the consumer must receive a worse service as a result, with **no offsetting benefit** from leveraging that would outweigh any competition impact.

These factors [described further in Annex 1] can be seen in past cases in the digital sector relating to leveraging (but not reverse leveraging) and have been tested in Court.[1] [2]

As we explain further in the next section, it is critical to recognise that outside these specific circumstances there is a lot of leveraging activity that creates substantial benefits for UK consumers. Furthermore, we are not aware of cases where reverse leveraging (or where conduct on a market where a firm does not hold market power) has been found to be anti-competitive.

3 LEVERAGING OFTEN BRINGS ABOUT GREATER COMPETITION, PROMOTES INNOVATION AND LEADS TO LOWER PRICES AND HIGHER QUALITY

A central insight of the economics of the boundaries of the firm, for which Oliver Hart won a Nobel prize in 2016, is that complementary activities are often best carried out together under common ownership. Competition regulators recognise that *"the integration of complementary activities or products within a single firm may produce significant efficiencies and be pro-competitive".* (See paragraph 13.)

This effect is at the core of successful firms, not just those with digital activities. Economies of scope are created by firms who innovate and expand organically in adjacent services to make the most of efficiencies and synergies. Innovation often occurs most efficiently and organically when it occurs inside the tent, rather than through arms-length commercial relationships with third parties active in the related market. For example, large department stores offer furniture and homeware as well as clothing; owners of telecom infrastructure also sell airtime and phones; TV distributors also commission their own original drama.

Research has shown strong evidence that innovation tends to build on related prior innovations, and empirical evidence shows that whilst technological advances in one field can advance progress in multiple neighbouring fields, the closer the link to the original innovation, the greater the likelihood of success.

[1] Judgment in Case T-612/17 Google and Alphabet v Commission (Google Shopping).

[2] Streetmap.EU v Google Inc., Google Ireland Limited and Google UK Limited [2016] EWHC 253 (Ch).

That is not to say that arms-length commercial relationships and merger activity cannot also be beneficial, but the ability to leverage a firm's own competitive advantages is often what makes exploration into adjacent markets feasible and appealing. As explained below, this means that leveraging can i) facilitate innovation which has a direct benefit to consumers, and ii) can strengthen competition by allowing new entrants to challenge incumbents.

3.1 LEVERAGING CAN ENABLE GREATER INNOVATION THAT BENEFITS CONSUMERS

Leveraging can promote innovation, particularly when there is a strong complementarity between the adjacent and core market. If there are potential benefits to the firm's core activity, there will be incentives to innovate in all sorts of adjacent markets, even if many do not pay off.

- Large companies are often able to **balance a portfolio of risk and innovation.** Not all innovation succeeds, and many experiments never achieve commercial success initially (or ever). These risks are best taken as part of a portfolio, as they are unlikely to happen as standalone ventures. In practice, larger firms are able to benefit from taking this sort of portfolio view, as they can hedge their bets across a range of ideas. Because success is not guaranteed, it is helpful when large firms are able to experiment.
  - Google Glass, Google+ and Google Hangouts are relatively unsuccessful ventures which are balanced by Chromebooks, Google Home, smartphones and a number of other successful hardware and software propositions.
  - Similarly, Amazon's Fire and Facebook's HTC First smartphones were regarded as failures that could not compete with the already appealing and well-established Apple and Android products.
  - Likewise, Microsoft's Bing search engine continues to have a much lower market share than Google.
- The result is that leveraging can encourage **both wider and bigger innovations**, resulting in better products, lower prices and better-value services or propositions for consumers.
  - For example, Apple's AirPods, Watch and TV all provide better choice and quality for customers, whilst encouraging innovation and competition in their respective markets. Each exists in highly competitive markets and provides a benefit to consumers in the form of new, imaginative products.
  - And although in early stages of development, Tesla's batteries and energy storage proposition, Powerwall, and Sky's Skyglass televisions are further examples of innovations in adjacent markets with clear benefits to consumers.
- Leveraging is often an inevitable feature of innovation because the ability to offer a new product relies on the **need for integration** with an existing service. Some complementarities can only be accessed by integrating a product or functionality into the core offering (and where it could be too risky and damaging to open the infrastructure to third parties in the same way).
  - For example, Amazon's Fresh grocery stores have recently revolutionised the grocery shopping experience by allowing customers to use their Amazon app to enter, pick up what they need, and "just walk out". The technology deployed and

user experience in this instance are completely new.[3] This innovation works by being integrated into the customer's wider relationship with the retailer.

- The same need for integration to access new markets can be seen elsewhere in retail. For example, Asda's standalone George-branded clothing stores were closed after a few years due to high rental costs which impacted profitability. The George clothing brand is successful due to its integration – both from a physical and branding perspective – with the core Asda offering, since it allows it to take advantage of high footfall and the low incremental cost of space.

While we cannot and do not argue that these innovations would have been blocked or challenged should the current proposals have been in place, the burdens of demonstrating user benefits ex ante are likely to have created impediments to these types of activities.

3.2 LEVERAGING CAN STRENGTHEN COMPETITION BY ALLOWING NEW ENTRANTS TO CHALLENGE INCUMBENTS

One of the main benefits of leveraging is its ability to strengthen competition and facilitate entry:

- Leveraging has the effect of strengthening competition in adjacent markets when it helps to **develop new business models**, and therefore **encourage market entry.** Technology provides an opportunity to fundamentally change the way consumers access products and services. Sometimes firms may be incentivised to try new ways of serving customers in-house because existing markets are not already set up to do so.
  - Apple's development of the iOS ecosystem enabled it to revolutionise the software market to become based around downloadable "apps" – a term not in common usage prior to the first iPhone in 2007. It has created a new industry facilitating a wave of new entry by UK app developers, whose revenues have grown from under £2bn to over £18bn over the last ten years according to industry research. Apple has estimated that iOS app development now supports over 330,000 jobs in the UK.
  - Amazon's Prime Now provides an example of testing and proving a rapid delivery concept, i.e. small basket grocery delivery within one hour, which has since encouraged further entrants into the market, including Chop Chop, Gorillas and Getir. Rivals have also responded to the Amazon Fresh innovation noted above – with Tesco having since launched similar technology with GetGo, and Sainsbury's having licensed Amazon's technology, spreading the benefits of innovation across the sector.
- Leveraging is often appealing to large firms because of the opportunity to **disrupt and challenge established market power** where customers face poor service and a lack of innovation. Leveraging a firm's synergies to challenge, rather than to interoperate with, existing players can have a substantial pro-competitive effect.

[3] Checkout-free shopping experience is not an entirely new concept for high street retail – both Tesco and Sainsbury's recently undertook and reversed their trials of till-less stores.

- For example, the innovations made by Apple and Google of adding high-quality cameras to phones – a move that transpired to be critically problematic for digital camera manufacturers – turned out to be beneficial to customers.
- Amazon's decision to become a Premier League partner challenged the current incumbents, Sky Sports and BT Sport, allowing increased viewing numbers through Prime.

4 THE DMU PROPOSALS RISK UNDERMINING THE BENEFITS OF LEVERAGING

The Government proposes to safeguard against problematic leveraging through the "Open Choices" principles incorporated into the design of codes of conduct. Most of these principles focus on the established competition concern: how a dominant firm might exploit its market power to disadvantage rivals in adjacent markets. However, one proposal (principle 2(e)) would mean widening the scope of regulation significantly beyond that:

*"Not to make changes to **non-designated activities** that further entrench the firm's position in its designated activity/ activities unless the change can be shown to benefit users."*

This extension in scope is motivated by the idea that regulation should also seek to prevent **"reverse leveraging"** – that presence in an adjacent or unrelated market might reinforce barriers to entry in the 'home' market where a firm already has an entrenched dominant position. This seeks to regulate how a firm develops services in areas where they have no dominant position – potentially where they have no market power at all.

The problem with this proposal is that it casts the net of regulation over *all* forms of leveraging, including the many pro-competitive and pro-innovation activities described above. As set out below, we think the broad scope of this proposal creates two main concerns:

- First, this proposal could ultimately harm consumers by limiting or even eliminating innovation, product development or existing service improvement in the UK. The result could be a movement away from innovation taking place in the UK, because conditions are unfavourable to experimentation and exploration.
- Second, the proposed 'get out' clause requiring firms to prove that the activities are beneficial is not sufficient, because the very nature of innovation means that it is impossible to know what will and won't work ex ante. The commercial reality is that freedom to engage in risk-taking and experimentation matters.

4.1 THE CURRENT PROPOSED LEGISLATION RISKS CAUSING HARM TO CONSUMERS, COMPETITION AND THE UK ECONOMY

There are significant risks to implementing regulation of the type proposed by principle 2(e). It could ultimately harm consumers by limiting or even eliminating innovation, product development or existing service improvement in the UK in a number of ways.

- The first risk is through **lost entry and weaker competition**. Regulation could just outright prevent the development of new and unique products and services that are better for customers and provide a new source of competition – in a way that simply will not or cannot be replaced or replicated by others.

- This regulation could lead to **product feature paralysis** as SMS firms lose the ability to respond to changing customer needs. Arguably any change in behaviour to exploit synergies could be construed as strengthening the position of the 'core' activities of the firm and could be considered to 'entrench' an SMS's position. It is inherent in all digital products that they require constant updating and improvement – including the ability to implement continuous improvements to existing customers seamlessly "over the air".
- The result would be **reduced experimental innovations** as regulation stifles the process of discovery in experimental innovations with uncertain benefits. The risk that – once those benefits have been found – they could be ruled non-compliant is even greater here because this type of regulation is novel and entirely untested. Even the application of the regime itself is likely to be uncertain. New product development and customer choice would suffer.
- Finally, consumers could lose out from **the heavy burden of compliance and delay**, with firms being unable to act until their proposals are approved by regulators. Regulation may create such a burden of compliance around innovation that opportunities with a high risk of failure are simply not pursued at all. In dynamic markets the speed of being able to introduce a new product or service, or react to one launched by a rival, can be critical – a delay to 'prove' to a regulator that such a product launch has net benefit may make it unattractive.

The result could be an **uneven playing field for UK-led innovation**, especially as this type of regulation is not currently part of the European Union's proposals for a Digital Markets Act. New ideas could be developed and rolled out in a way that holds back or excludes the UK market. A core part of the UK's industrial strategy is to maintain its position as "an open enterprising economy, built on invention, innovation and competition" (see page 6). But the current proposals potentially put this reputation at risk. Instead, successful innovation may then be developed outside the UK, with products being launched in the UK only once it becomes clear that they are compliant and worth the regulatory salt. UK consumers may miss out on even 'simple' improvements in products and services offered by SMS firms in non-designated activities. This would be not only counterproductive but also damaging to the UK's ambition "to be the best place to start and run a digital business" (see page 157).

4.2 PROVING BENEFITS IS NOT A COMPROMISE BECAUSE IT IS IMPOSSIBLE TO PROVE EX ANTE WHETHER INNOVATION WILL WORK AND BENEFIT CONSUMERS

In theory, the proposals do allow for beneficial innovations to take place. But only once permission has been obtained from the regulator. This requirement for firms to demonstrate that any changes in non-designated activity would benefit users in advance ignores the commercial reality of how many organisations function, for a number of reasons:

- Many organisations foster a **culture of experimentation.** A combination of curiosity and an exploration of the unknown through research and testing means that everyone is encouraged to experiment, learn from failure and put forward new ideas to make the customer offering more appealing. Practically, it would be very difficult to maintain a culture of devolved, continual innovation if each initiative required regulatory review and support.

- Experimentation necessarily means **embracing trial and error**. Experimentation can and should happen with unknown benefits. Because innovation is a process of discovery, it is a serious error to assume that synergies or customer responses are or can be always known in advance. ("To invent, you have to experiment, and if you know in advance that it's going to work, it's not an experiment.") This experimentation cannot be predicted, and certainly not proved, precisely because what will work is unknown.
- Furthermore, the term innovation is often associated with 'big bang' disruptive changes like new products or services. But in reality **innovation means many things**, and the overwhelming majority of it happens continuously, incrementally and organically:
  - While the first e-commerce sites may have disrupted the way we shop online, innovation today is more likely to focus on making the process a few clicks faster.
  - Supermarkets' day-to-day innovations might include working with farmers to extend the UK growing season of strawberries from weeks to months; experimenting with the store placement of strawberries throughout the day to minimise wastage; or refining algorithms which use weather forecasts to predict demand for strawberries on a given day for a given store, and therefore match supply. This is what innovation looks like for just one product (and big supermarkets sell tens of thousands of products).

While the above examples highlight innovations in the core activity, these innovations are just as relevant in large firms' non-core activities, and in many cases are synonymous with product improvements and service updates.

5 CONCLUSION

Large digital firms, those who will likely be subject to the new SMS regime, are a critical source of innovation and competitive challenge when they expand into adjacent markets. Whilst some leveraging can be harmful, this will almost always relate to activities where an SMS firm holds a position of strong market power. Expanding the scope of regulation beyond this to cover all of the activities of an SMS firm affects a wide range of pro-competitive and pro-innovation activity that is beneficial for consumers. The fact that a firm offers new and better products in a market where it faces strong competition should not be seen as a problem.

Regulating to require permission for all this activity cannot be a proportionate approach. Legislation should instead ensure that the DMU takes a more targeted approach. That can and should be done by focusing efforts on using established criteria to identify those cases where leveraging is of genuine concern.

ANNEX 1 – FACTORS RELEVANT TO THE IDENTIFICATION OF POTENTIALLY PROBLEMATIC LEVERAGING ACTIVITY

(a) The significance of the SMS firm's market power in the non-designated market

(i) Is it likely that the SMS firm would be able to use its position to materially affect or entrench its designated activity?

(ii) Does the SMS firm have assets or capabilities that mean it would be able to prevent others succeeding in that market and gaining their own source of leverage into new markets?

(b) The strength of link to the designated activity

(i) Is there significant overlap in the customers of the designated and non-designated activities?

(ii) Is the relationship with the non-designated activities essential to the ability to offer a compelling product in the designated activity?

(iii) Is the non-designated activity likely to represent a particularly credible or unique route for new entry into the designated activity?

(c) The competitive position of rivals

(i) Is the SMS firm challenging rivals that also have market power in the non-designated activity?

(ii) Do rivals also enjoy competitive advantages from leveraging their other activities outside the market?

(iii) Is there a history of poor customer outcomes or a lack of innovation in the markets of the non-designated activities?

(d) The nature of the innovation or service improvement

(i) Does the change materially increase the extent of linkage with the designated activity?

(ii) If it does, is it nonetheless the case that:

(A) the change responds to customer demand, or improves the customer experience in either market?

(B) there is a reliance on synergies with the designated activity without which it would not be technically or economically feasible?

(iii) Does the change involve experimenting with an entirely new type of product or new business model that is different from those of rivals?

AUTHORS

DAVID FOSTER
Director

TARA CHAPMAN
Manager

This briefing paper represents the authors' own views. It was funded and produced in collaboration with Amazon UK.

WANT TO KNOW MORE?

WWW.FRONTIER-ECONOMICS.COM

HELLO@FRONTIER-ECONOMICS.COM

+44 (0) 207 031 7000