STAY IN YOUR LANE?

Regulators are grappling with the competitive effects of growing business ecosystems

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Firms with a strong position in one market sometimes attempt to enter new ones. Take Uber, for example. Founded in 2009, and initially focusing on becoming the world's leading ride-hailing app, Uber started branching out into food delivery (2014), freight transportation (2017) and package delivery (2020).

This pattern isn't unique to Uber. Supermarkets today don't just offer food and drink but also clothing, petrol and household items. Google has moved beyond search engines into web browsers, maps, video hosting, activity trackers, virtual assistants and much more besides. Nor is this a new phenomenon. Back in 1980 more than 75% of firms in the Fortune 500 list made sales in at least two broadly defined industries.[1]

When firms like Uber enter new markets they are generally thought of as pursuing an 'offensive' growth-orientated strategy associated with positive outcomes for consumers, who benefit from more choice, lower prices, improved quality and greater innovation. For example, Uber Eats, Uber's food delivery brand, challenged UK market incumbents Just Eat, Hungryhouse and Deliveroo, spurring competition on customer discounts, delivery times and restaurant commissions.

Recently, however, the UK Competition and Markets Authority (CMA) has voiced concerns that entry by an established (particularly digital) firm into new markets can be a 'defensive' strategy employed to protect its position in an existing core market. Here we ask: what would need to be true for such diversification to have anti-competitive effects? And what would be the appropriate regulatory response in this situation?

UNDERSTANDING THE CONCERN

The idea of firms using market entry as a defensive strategy to protect a core product/service was first raised by the CMA in its Digital Advertising and Online Platforms Market Study, which

[1] Davis et al. (1994), The Decline and Fall of the Conglomerate Firm in the 1980s: The Deinstitutionalization of an Organizational Form. Available at https://webuser.bus.umich.edu/gfdavis/Papers/Decline%20and%20Fall.pdf

found that by “surrounding its core service with a large number of complementary products and services” a digital firm can “insulate its most profitable service from competition”. By managing “to convince consumers to operate to a large degree within their ecosystem online, then a new entrant would need to compete on many fronts to displace them” [page 56] – so protecting the digital firm from competition.

Similarly, in its advice to the UK Government through the Digital Markets Taskforce, the CMA said that “several of the most powerful firms offer a wide range of products as part of an ecosystem. Several policy reports and stakeholders have emphasised the importance of such ecosystems of products in protecting a firm’s market power in an activity. Therefore, this factor may be particularly relevant where an activity plays an important role in entrenching the firm’s position.” [Appendix B, page 17][2] The CMA noted that an ecosystem of products could be considered a factor in determining whether a firm has Strategic Market Status (SMS) and some commentators have suggested regulating new entry by digital firms (e.g. Condorelli and Padilla, 2020).

BREAKING IT DOWN

The idea that by introducing a new product a firm extends its reach with customers, and makes it more difficult for rivals to challenge its position, is superficially appealing. But is it correct? Or are there flaws in this apparently seductive logic?

To explore this further, suppose a firm with a dominant position in a core market is facing a rival with the ability to enter that market and mount a challenge. Under what conditions would entry by the dominant firm into a new target market protect its position in the core market and, by harming overall consumer welfare, be anti-competitive?

In our view, two conditions would need to be met:

- First, there must be a credible theory for **entry deterrence**. Why would the rival have previously been able to enter the core market but, once the dominant firm has branched out, no longer be able to effectively do so?
- Second, the immediate pro-competitive and welfare effects associated with target market entry would need to be **outweighed** by longer-term anti-competitive effects.

We consider each point in turn below.

A CREDIBLE THEORY FOR DETERRENCE

It is not obvious why the dominant firm’s entry into the target market would impact its rival’s ability to contest the core market. Why would Uber offering food delivery make it more difficult for a competitor to branch into ride-hailing? Why would supermarkets selling clothing prevent other firms entering groceries? Why would Google offering Hangouts (a video-conferencing app) make it harder to break into search? Any

[2] This is related to a separate concern that digital firms can offensively leverage their strength in a core market into other activities, but we do not cover this.

anti-competitive theory would need to substantiate what new entry barrier is created by the dominant firm's presence in the target market.

- First, it could be argued that profits from the target market are needed to enter the core market. But that doesn't seem plausible – either it is incrementally profitable for the rival to plunge into the core market or it is not. As long as the rival originally had the external finance to enter, it would not need additional profits from the target market.

- Second, a related theory is that a rival may need to reach a certain scale (in terms of, say, number of users or data assets) in order to enter the core market. Again, it is not clear how the dominant firm's entry into a target market would prevent this. One suggestion is pre-emption (Condorelli and Padilla, 2020): the dominant firm could enter the market of a potential rival and, by outcompeting it, could prevent that rival from reaching the necessary scale. This, however, raises several questions: why is scale important? Why can it be built up only in the target market and not in other markets? Why isn't there room for more than one firm in the target market? Why can the dominant firm outcompete the rival in the target market (particularly if the rival is an incumbent in that market)? Regulators such as the European Commission have found that online search is a difficult market to enter effectively, but it is not clear that a rival firm would have a much easier time entering search if it had a stronger position in video conferencing.

- Third, if the dominant firm can build up power in the target market, and the target market is an important gateway to the core market, then perhaps it can direct users towards its product in the core market. For example, a web browser could be used to direct traffic towards a search engine with default options and bundling. This theory, though, is really a traditional tying theory of harm. Whether the use of defaults and bundling of services is considered anti-competitive or not, this is a separate issue from the entry into web browsers itself. Without the defaults and bundling, it is less clear that entry in itself raises barriers to rivals.

- Finally, it may be the case that the target market and core market work so well together that every customer wants to buy both products together, or there may be significant cost savings in producing the two products together (i.e. economies of scope). If the dominant firm starts supplying both products, then rivals may benefit from following suit to compete effectively. However, if the economies of scope from being in both markets really are large, particularly on the demand side, this suggests that rivals should be trying to enter both markets for the benefit of consumers. Doing so should become the default response. All smartphone providers now include built-in cameras, all cars are manufactured with media players, and supermarkets all sell not only food and drink but also household items.

None of the first three theories provides a particularly convincing reason as to why a rival that had previously been able to enter the core market can no longer effectively do so after the dominant firm has made its presence felt in a target market. The fourth theory might mean that it is difficult for a rival to enter only one of the two markets. But this is because of the substantial pro-competitive benefits of producing and/or consuming two products jointly. Would consumers really have been better off if regulators had prevented smartphone manufacturers from adding cameras to their phones?

WEIGHING THE PROS AND CONS

Even if a credible theory for entry deterrence is developed, entry by the dominant firm would be harmful to consumers only if any anti-competitive effects in the core market outweigh the direct, pro-competitive effects of its breaking into the target market.

If the dominant firm was the first entrant in the target market, it would be immediately addressing an unsatisfied consumer need. Alternatively, the target market may already have an incumbent, in which case entry by the dominant firm would be expected to lead to more choice and greater competition on prices, quality and innovation. Entry by the dominant firm into the target market would immediately generate a period of increased competition. Indeed, the mere threat of entry may be enough to keep the incumbent on its toes.

There may also be pro-competitive benefits in the core market. As noted above, the only scenario where exclusionary effects on the core market appear possible is also one in which the integration of products and services can lead to efficiency savings, potentially reducing prices, and may make it easier for consumers to access a range of different services.

For such entry to be judged anti-competitive in the round, these more-immediate pro-competitive effects would therefore have to be outweighed by longer-term (and likely much more speculative) anti-competitive ramifications.

SO WHAT?

The conditions under which a firm's entry into a new market protects its position in a core market and harms consumers overall appear quite restrictive. So, while effects will vary from case to case, the arguments set out above suggest a critical view should be taken of any notion that new entry is anti-competitive.

Regulation in this area would need to consider the risk that it could stifle rather than promote competition. If regulation effectively requires incumbent firms to obtain permission to enter new markets and build new products, or increases the potential regulatory risk of doing so, they could delay or even abandon any plans to branch out.

This is likely to be particularly true in digital markets, where innovation is rapid and frequently built directly into the very design of products. Moreover, there is often no clear boundary in digital markets between what constitutes novel features/quality improvements to a core proposition versus entry into an entirely new market. Would you consider Netflix's recent innovations – Netflix Party, Netflix Podcasts and Netflix Originals – to be part of its core offering or entry into new markets?

As such, any regulation would need to be justified with particularly strong evidence that the (uncertain and long-term) benefits would exceed the (certain and immediate) costs.

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