RBB Brief 67

JULY 2024 rbbecon.com

No substitute for economics: the Commission's updated market definition notice

In February 2024, the Commission issued an updated and significantly expanded version of its market definition notice (the "Notice").[1] The publication of the original notice in 1997 (the "Old Notice") marked a major change in approach and was an important step in the development of the Commission's enforcement practice towards a more economic approach.[2] After more than 25 years, a period during which the Commission has gained a considerable amount of experience and many new developments have occurred (such as the growth of digital markets and ecosystems), an update was clearly due.

The Notice is largely to be welcomed. It restates the continued value and importance of market definition in all relevant European competition cases, including mergers and Article 102 investigations. Importantly, it maintains the core principles of demand-side and supply-side substitution, stressing the importance of economic analysis in market definition. The Notice also explains how the existing market definition framework can be applied to digital markets.

However, when defining geographic markets, the Notice downplays the role of demand-side substitutability in favour of greater prominence of less (economically) relevant and vaguer principles based on the case law. As this Brief explains, this marks a departure from the otherwise sound economic basis that the Notice rightly adopts.

A continued key role for market definition and economic evidence

If page length is a measure of progress, the Notice (at 35 pages, compared to fewer than 9 for the Old Notice) shows that the Commission's market definition practice has evolved considerably over the past 25 years. Nonetheless, the core principles of market definition remain.

In particular, the Notice confirms the hypothetical monopolist test ("HMT") as the relevant conceptual framework for market definition.[3] Put briefly, under the HMT, a relevant market is found when a single supplier of all products within the putative market could profitably sustain a price above competitive (or prevailing[4]) levels.[5]

Like the original version, the Notice highlights the importance of both demand- and supply-side substitution to identify sources of effective competitive constraints on firms.[6] Moreover, the Notice reaffirms the importance of market definition as a first step in an assessment of market power.[7] Further, the Notice helpfully clarifies that while market shares in a properly defined market can be a guide to market power, this is not always the case.[8]

1. Commission Notice on the definition of the relevant market for the purposes of Union competition law, 22 February 2024, C(2024)1645.

2. Commission Notice on the definition of relevant market for the purposes of Community competition law, 9 December 1997, 97/C 372/03.

3. Paras 27-31.

4. If market definition is being used to shed light on the existence of market power, the correct conceptual benchmark is whether price(s) could be sustained profitably above competitive levels. In the case of a horizontal merger, the question addressed by market definition is different, namely whether the merger would cause prices to increase relative to prevailing (or counterfactual) levels (which need not be competitive levels).

5. In other words, one considers whether a small but significant non-transitory increase in price ("SSNIP") is profitable. The HMT may also be implemented in relation to other parameters of competition. For example, the HMT can be applied by considering a change in quality as opposed to price, and assessing the effect of a small but significant non-transitory decrease in quality ("SSNDQ"). The Notice acknowledges this (see, for example, para 30).

6. See, e.g., para 23.

7. Para 8. Footnote 14 defines market power as the ability to profitably maintain prices above (or maintain output below) competitive levels for a period of time.

8. Paras 106 and 110.

The Notice extensively discusses the various types of economic evidence on demand- and supply-side substitution that can inform market definition.[9] For example, analyses of the impact on customer switching of past changes in supply ("shocks") can provide useful insights into demand-side substitution.[10] Where sufficient data are available, quantitative measures of demand-side substitutability may be obtained by estimating price elasticities and/or diversion ratios.[11] In practice, these estimates can be used to determine whether products compete closely enough to be within the same relevant market, or whether they are distant substitutes that do not constrain each other to any material degree. The Commission may also rely on evidence on how customers are likely to react to hypothetical changes in supply conditions.[12] In this context, the Notice usefully conveys a willingness to deal with ad hoc surveys conducted for the purpose of transactions, provided these are carefully designed and are based on representative samples of customers.[13]

Market definition is a relevant tool in the digital sector

The digital sector is often associated with strong network effects and zero price services, which can raise challenges for market definition.[14] These features have led some commentators to propose bypassing market definition in investigations involving large digital service companies and simply presuming such firms to be dominant (i.e., to hold significant market power).[15] Relatedly, and concerningly, in the UK, the CMA proposes not to define markets formally for the purpose of assessing whether firms have strategic market status (and hence entrenched and substantial market power) in its draft guidance on its digital markets competition regime.[16] In contrast, the Notice stresses that market definition remains crucial for assessing market power, even in the digital sector. To this end, the Notice describes the Commission's approach to market definition in the presence of multi-sided platforms and digital ecosystems.

In relation to multi-sided platforms, the Notice indicates that the Commission may define a single market encompassing the platform service on all sides, or separate markets for each side. When substitution possibilities are similar for platform users (irrespective of which "side" of the platform they use), this may lead the Commission to define a relevant market for platforms, in particular if indirect network effects are significant. Alternatively, when the choices available to users depend on which side of the market they are on (e.g., whether they are buyers or sellers), defining separate product markets might be more effective to assess market power, in particular when users on one side can substitute to non-platform alternatives.[17] In this way the Notice rightly highlights the flexibility of market definition, which can be adapted appropriately to the facts of the case.[18]

The Notice also provides a helpful reminder that the standard market definition framework remains relevant for digital ecosystems. As the Notice explains, the complementary products within an ecosystem can be analysed as competing bundles or, depending on the facts, as aftermarkets (i.e., where purchases of a "primary" core product lead to consumption of complementary "secondary" products).[19]

In summary, the Notice confirms that the established market definition framework still applies, even as digital markets continue to evolve.

9. Paras 48-75.

10. Para 51.

11. Para 53.

12. Para 54.

13. Para 81.

14. Customers often do not pay a monetary price for digital services or content but instead provide firms with their private data in order to consume digital services "for free". Where there is no price, the HMT can be implemented by considering a SSNDQ as noted above.

15. See, for example, Jacobides and Lianos (2021) who consider that defining narrow markets based on a single product fails to account for "the competitive dominance that a powerful ecosystem orchestrator/ gatekeeper enjoys". Michael G. Jacobides and Ionnis Lianos, "Ecosystems and competition law in theory and practice", Industrial and Corporate Change, 2021, 30, pp. 1199-1229.

16. CMA consultation on "Guidance on the digital markets competition regime set out in the Digital Markets, Competition and Consumers Act 2024" 24 May 2024, paras 2.10, 2.43. See also para 4.9.

17. Para 95.

18. In the UK, the Competition Appeal Tribunal ("CAT") in Compare The Market took the view that each side of multisided platforms should always be assessed separately, contrary to the CMA's approach in this case. Though, in principle, the CAT's approach still allows for a single platform market to be defined when each side is found to be subject to the same competitive constraints. See BGL (Holdings) Limited & Others v CMA, [2022] CAT 36, para 147.

19. Para 104.

Geographic market definition: homogeneity versus substitutability

From an economic perspective, the appropriate approach to product market definition, i.e., one that is focused on substitutability, applies equally to geographic market delineation.[20] The extent of demand- and supply-side substitution was clearly identified in the Old Notice as a core feature of both product and geographic market definition. In particular, the Old Notice highlighted that the scope of the relevant geographic market hinges on the extent to which customers "would switch their orders to companies located elsewhere" in response to a change in relative prices.[21]

In comparison, the current Notice follows the case law and recent Commission enforcement practice by focusing to a greater degree on whether conditions of competition are "sufficiently homogeneous".[22] Put differently, while substitution has not been entirely disregarded, it is presented as having become less central to the analysis. The Notice does indicate that demand-side substitution is important when suppliers do not discriminate between customers based on their location and/or by geographic areas (e.g., as is often the case for supermarkets, airports, and petrol stations), or when they do not negotiate with individual customers.[23] But when suppliers can discriminate between customers based on their locations or by geographic areas (which happens also when suppliers negotiate with individual customers), the Notice emphasises that conditions of competition must be sufficiently homogeneous for areas to belong to the same relevant market.[24]

There are a number of problems with this approach.

- The Notice suggests that demand-side substitution is a more important consideration when suppliers do not negotiate with (or price differentiate between) individual customers than when suppliers engage in such negotiations. There is no sound economic basis for this view. This is because when suppliers negotiate with individual customers, their bargaining leverage depends largely on the buyer's outside options (i.e., other suppliers to which the buyer can switch should prices rise). In other words, while the ability to price differentiate between customers may impact market definition, the concept of demand-side substitution for any customer group being considered is nonetheless central even when prices are negotiated.

- The Notice suggests that conditions of competition are "usually" not sufficiently homogeneous when market shares vary significantly across areas.[25] However, leaving aside the risk of circularity when markets are defined by reference to market shares, two areas can belong to the same market despite having different structural features. Consider, for example, two neighbouring Member States, A and B. A has three suppliers of a standard industrial product, while B has five. Transport costs between countries are a negligible share of costs. Suppliers in both countries have substantial spare capacity and domestic competition is effective. For that reason, limited trade is observed between countries A and B, despite the absence of barriers to trade. In this context, because the market structures differ, one might presume (applying the logic of the Notice) that each Member State is a separate market. In practice, however, higher prices in country A could attract a substantial inflow of volumes from country B (and vice versa). If so, the "true" relevant market – based on assessing substitution patterns through the HMT – could well be A and B together.[26] In short, the Notice could usefully have made clearer the key point that differences in market structure need not imply the absence of scope for effective demand-side substitution.

20. Products have numerous features, including not only price and quality but also the location of sale. That is, from a consumer perspective, where a product can be purchased can be thought of as a product feature. Consider, for example, two identical products, A and B, sold at the same price in the same area. From a consumer perspective, there is no difference between: (i) increasing the price of A by 5%; and (ii) keeping the price of A unchanged but making it available in a less convenient location (such that it costs the consumer an amount equivalent to a 5% price rise in terms of hassle to purchase the product). Logically, if it makes sense to employ the HMT framework for product market definition, then it is right to apply the same framework for defining geographic markets.

21. In para 29, the Old Notice rightly draws a parallel between product and geographic market definition. It states (in relation to geographic market definition): "The theoretical experiment is again based on substitution arising from changes in relative prices, and the question to answer is again whether the customers of the parties would switch their orders to companies located elsewhere in the short term and at a negligible cost."

22. See, e.g., para 38.

23. In such cases, the Notice indicates that the geographic market should be based on supplier location, see para 40.

24. In such cases, the Notice indicates that the geographic market is centred around customer location, see para 41.

25. Para 64.

26. Asymmetric competitive constraints may also matter. For example, even if conditions of competition are dissimilar in two areas (X and Y), suppliers in area X may exert a strong competitive constraint on suppliers in area Y (even if the reverse is not true). If the aim is to understand constraints on a supplier in area Y, then the relevant market may be X+Y. If the issue is to identify constraints on a supplier in area X, the relevant market may be X alone.

A more general point is that the Notice could have done more to emphasise the value of the HMT thought experiment to assess the strength of the competitive constraint from imports. While the Notice rightly acknowledges that any existing imports should count as part of the market share assessment, it has missed a chance to clarify the critical point that the competitive constraint from imports may be substantially greater than current levels of imports would suggest.

Suppose, for example, that imports currently account for 10% of sales in the EEA but, if prices in the EEA were to increase by 5-10%, then imports would reach a 30% share because additional production from spare capacity outside of the EEA could rapidly be brought into the EEA. In this case, it would be incorrect to ignore spare capacity outside of the EEA that would be quickly diverted to the EEA in the event of a SSNIP. Put another way, even if spare capacity is located in a country where conditions of competition are not sufficiently homogeneous, this does not mean that this capacity is outside the relevant market.

This reflects a broader concern that, without applying the HMT framework, there is a risk that supply-side constraints are not given their due weight. This risk is evident from the statement in the Notice that supply-side substitution is only relevant when “most, if not all, suppliers are able to switch production between products in the range of related products”.[27] A proper application of the HMT instead suggests that a putative market should be widened if a sufficient proportion of suppliers can switch their capacity so as to defeat a hypothetical price increase. The relevant market should then include this capacity.

To reconcile the case law with economic analysis, the Notice could have stated that conditions of competition between two areas can be “sufficiently homogeneous” where sufficient demand- and/or supply-side substitution exists between them such that they form part of the same relevant market. However, the Notice has not seized this opportunity.

Conclusion

In summary, we welcome most aspects of the Notice. It rightly highlights the importance of the HMT framework and its component parts, demand- and supply-side substitutability, when defining the relevant product market. These concepts have withstood the passage of time and gathering evidence on them remains a key part of a market power assessment. The Notice also rightly stresses that the market definition framework is sufficiently flexible that it can be applied appropriately to the digital sector.

However, when it comes to defining the relevant geographic market, the Notice takes a step backward. It downplays the core question of how customers would respond to a change in relative prices, which featured in the Old Notice, and gives greater weight to the less relevant and vaguer question, found in the case law, of whether conditions of competition across areas are sufficiently homogeneous. The Notice misses the opportunity to shape the case law by emphasising that sufficient substitutability is what matters rather than sufficient homogeneity.

Ultimately, the value of any Notice hinges on its real-world application. The Commission is to be congratulated (subject to the above comments) for setting out an approach to market definition that is firmly rooted in economics. However, whether the enforcement practice of the Commission and national competition authorities will live up to the Notice’s promise remains an open question.

27. Para 33.