

Defining Platform Markets: An indirect challenge

- **Economic regulation of digital platforms should start with a proper market definition**
- **The hypothetical monopolist test works well in linear markets but faces challenges in two-sided platform markets**
- **The economics of indirect constraints may point the way to proper market definition**

The power of digital platforms is the subject of much political and social concern in many countries. Some politicians and other commentators are expressing a need for their market power to be reigned in through regulation. However, applying economic regulation means following a process that begins with defining the relevant market. In this edition of Hexagon, we consider how the economics of indirect constraints may be a useful addition to the traditional SSNIP test.

All competition cases and market investigations begin with a definition of the market: issues within the boundary are investigated whilst those outside are ignored. The standard tool for defining a market is the well-known Hypothetical Monopolist Test (HMT), which examines whether or not a small but significant non-transitory increase in price (SSNIP) by a monopolist would be profitable. The HMT works well in one-sided, or linear, markets but faces a particular challenge in two-sided platform markets: how much of the price rise is passed through from one side of the platform to the other and what effect would that have on consumer switching?

Two types of platform markets have been usefully identified: transaction and non-transaction¹. In a non-transaction market there is no direct relationship between the two sides of the platform. Social media platforms are an example of such non-transaction markets. The two sides are the advertisers who fund the platform and users who may get access at no financial cost, but there is no direct relationship between them. In a transaction market the platform facilitates a trade between two parties. Accommodation platforms and ride-hailing apps are examples that facilitate a trade between hosts and guests or drivers and passengers.

Digital platforms have been usefully divided into two types: non-transaction and transaction

Defining non-transaction markets using the HMT is relatively straight-forward, though may have some twists. However, defining transaction markets requires more consideration.

We start here with the easier case. Suppose a social media platform is free for the user side and funded by advertising paid for by a variety of companies who wish to sell to social media users. In the simplest case the competition authority would seek to establish if the hypothetical monopolist platform could raise the price of advertising by 5-10% profitably.

If it could do so then the market would be defined as on-line advertising on social media, but if advertisers would switch to an alternative medium, the market definition would be broader and encompass that additional medium.

In this case, the HMT works in much the same way as in a normal linear market. However, there is a twist. The hypothetical monopolist may decide to share the price rise between both sides of the platform in some proportion, by introducing some form of membership fee to users. The positive network effects for users of membership of the social media platform may mean they are happy to pay a small fee and the reduced price rise for advertisers may stop them seeking a substitute. This

would make the SSNIP profitable, but does it too narrowly define the market if a differently distributed SSNIP would make be unprofitable?

Let us now turn to the more complex question of transaction markets and use the example of a holiday accommodation platform, the best known of which is Airbnb but there are several others such as Flipkey and VRBO.

In this case the host charges the guest for accommodation and the platform charges a booking or service fee to the guest, in addition to the accommodation fee. As we are interested in the market for platforms, the SSNIP is applied to the booking fee only. Platforms for other services use different models and charge the booking fee to the service provider, which they may pass on to the service user in some proportion.

The challenge this presents for the HMT is that the booking fee is only a small proportion of the total fee: say 10 - 15%. Where the equivalent of the booking fee is charged to the service provider, the extent to which it is able to pass any price rise

through to the customer is an important consideration.

Competition authorities seeking to define these markets can learn from the economics of indirect constraintsⁱⁱ. Based on previous work SPC Network has undertaken on indirect constraints, we can put forward a three-part framework that is relevant to platform markets for competition authorities to consider.

A SSNIP on one side of the platform may translate to a much lower price rise on the other side and may lead to too narrow a market definition

Two what extent is the SSNIP paid by the “guest” side of the platform? In the case of accommodation platforms it appears that all of the SSNIP is paid for by the guest, although in some other models at least some may be absorbed by the service provider. This is equivalent to a question in the analysis of indirect constraints about the proportion of a SSNIP a retail access seeker can pass through to the end

customer. It is important because of the effect it has on the price paid by the service user. Clearly the more of the price increase that can be passed through, or charged straight to the guest side of the platform, the higher the price increase they face.

What is the ratio of the booking fee to the total price? This ratio also has an effect on the price rise on the demand side of the platform. In the case of accommodation with a booking fee of around 10 - 15% of the final price, a SSNIP of 10% on the booking fee would represent an increase of just 1 to 1.5% in the total price paid by the guest. The booking fee would have to double for the service user to be subject to a SSNIP.

Where the booking fee equivalent is charged to the service provider rather than the end customer the price increase for the guest is a function of both the ratio and the amount that can be passed through by the provider.

The ratio means that a SSNIP of 10% may translate to an end user price increase that is much lower and

so may show a SSNIP as profitable and may result in a narrower market definition than is in fact the case.

What is the expected level of switching by consumers to an alternative product? Steps one and two together give an estimate of the retail price increase that could be expected to result from the hypothesised price increase. The next step is to attempt to estimate the level of switching that would result from this. In formal models the impact of the retail price increase is captured by the retail price elasticity, but the relevant price elasticity is unlikely to be available to authorities.

An alternative approach is to attempt to make an informed judgement about how likely consumers will be to switch following the retail price increase. In doing so, it is important that relevant authorities recognise the specifics of the market rather than relying on general estimates of switching behaviour and take into account any switching costs.

The most likely effect of these three questions is that a digital platform market is defined too narrowly. Whereas a person booking holiday

accommodation may perceive a traditional booking agent and a platform to be alternatives products, the HMT may not place them in the same market.

Does this mean the HMT is not applicable in platform markets and that competition authorities should not use this established economic tool? Probably not, but it does suggest that they may want to consider whether the resultant market definition leads to the unnecessary application of economic regulation. Instead authorities may first consider what products are likely to be seen by consumers as serving the same need and only use the HMT to establish if more marginal substitutes are in the same market.

ⁱ See Filistrucchi, L., Geradin, D., Van Damme, E., & Affeldt, P. (2014). Market definition in two-sided markets: Theory and practice. *Journal of Competition Law & Economics*, 10(2), 293-339.

ⁱⁱ European Commission (2014), 'Commission staff working document explanatory note - Accompanying the document - Commission Recommendation on relevant product and service markets within the electronic communications sector susceptible to ex ante regulation in accordance with Directive 2002/21/EC of the European Parliament and of the Council on a common regulatory framework for electronic communications networks and services', p45.