

May 2018

Ex ante regulation of digital platforms: Challenges for the three criteria test

- *There have been a number of calls for digital platforms to be subject to regulation like utilities.*
- *The Three Criteria Test is a well established means of determining if a market is susceptible to ex ante regulation*
- *Digital platforms present some challenges for the Test, but it is better to use a rational analysis than make immediate judgements.*

Do digital platforms like Facebook and Google play such a large part in our lives that they should be regulated like utilities? An article in *The Economist* recently identified such regulation as big tech's biggest long term threat¹. Would such regulation be justified or is it a political and emotional response to fear that such large organisations are taking over our lives? This edition of Hexagon considers the challenges to the "three criteria test", used to identify electronic communications markets susceptible to *ex ante* regulation, if it were applied to digital platforms.

Digital platforms are used for many purposes: some for interaction with friends and people who share a common interest, others for trading goods and services. The former are broadly described as social media and the latter as marketplaces, though both may have characteristics of the other. For many people social media in particular has become as indispensable as basic utilities like sewage, electricity and gas. Some platforms have very high market shares and apparently face little or no competitive pressure.

It is this combination of indispensability and high market shares that have led to calls for *ex ante* regulation, possibly even their break-up, to be imposed on some platforms. Whether or not markets should be subject to *ex ante* economic regulation ought to be a matter for rational analysis rather than political or emotional pressure and a methodology, the "Three Criteria Test", already exists for making such a decision. But, would it be fit for purpose if applied to digital platforms?

The Three Criteria Test, which is used by the European Commission and national regulators of electronic communications, considers three questions:

- Do potential entrants face high barriers to entry?
- Is the market trending towards effective competition?
- Is competition law sufficient to deal with any competition problems?

If the answers are, respectively, yes, no and no then the market is considered susceptible to *ex*



ante regulation and so reviewed to establish if one or more firms is dominant in that market.

The Three Criteria Test was developed for typical “linear” markets and where one firm had inherited a monopoly or dominant position from an era before the introduction of competition. These characteristics do not apply to digital platformsⁱⁱ. So what, if any, challenges do digital platforms create for the Three Criteria Test?

High Barriers to Entry

Incumbent telecoms operators are protected from entry by large economies of scale. Digital platforms, by contrast may be protected by direct and indirect network effects: the more participants there are on the two sides of the platform, the more attractive the platform is to potential users on both sides.

Any new entrant attempting to challenge an existing platform therefore faces the challenge of attracting a large number of parties to both sides of the market. To do so, it must not only

provide greater utility than the platform it wants to challenge, but must also overcome the deep-seated preference many consumers will have for that incumbent.

The positive network externalities in some digital platform markets mean that the market may “tip” towards a single or dominant platform. Whilst markets may subsequently tip away from the incumbent to an entrant, the challenger faces a difficult task to persuade people on both sides of the market away from the platform they prefer. That preference is affected by both the intrinsic utility of the service and also the size of the network. Any authority considering *ex ante* regulation would therefore need to consider the extent to which network effects create a barrier to entry. Only if it finds such barriers to entry would it move on to the second criterion: the trend towards effective competition.

Trending towards effective competition

The Three Criteria Test usually considers competition within the market and therefore

traditional measures such as market shares and prices: if the dominant firm’s market share and prices are moving towards a competitive level, then the market as a whole may be trending towards competition.

The potential for reputational damage may make a network market more contestable than seen at face value

Where there are strong network effects, however, competition may be *for* rather than *in* the market. So how can we judge if there is still effective competition? A prospective regulator may consider whether the market is “contestable”, which is normally only the case when there are low or non-existent barriers to entry. However, two factors may come together that create contestability: low consumer switching costs and the importance of the network’s reputation.

Users face little or no switching costs between some digital market places. It is quite feasible

for consumers to have several ride-hailing apps available to them, for example – a phenomenon known as “multi-homing”. This lowers switching costs if one platform suffers some reputational damage. Such harm to one platform could result in rapid switching to an alternative. Facebook and Uber have both suffered some reputational damage recently that may not have undermined their market position, but does highlight platforms’ vulnerability.

The Three Criteria Test may have to be adapted to consider not so much whether the market is trending towards competition, but how vulnerable the market is “tipping”, which could see demand move rapidly away from the market leader to a global or local challenger.

The effectiveness of competition law

Competition law is well developed to deal with most problems, but digital platforms create a number of new challengesⁱⁱⁱ. Likewise, digital platforms create problems for *ex ante* regulation.

The type of problem *ex ante* regulation addresses is usually related to potential exclusionary practices whereby the incumbent platform prevents competitors from entering the focal market or one closely related to it. This type of behaviour can be seen in platform markets, as the recent European Commission finding against Google demonstrates^{iv}.

The normal *ex ante* remedy is to mandate the dominant provider to allow rivals access to an essential facility on non-discriminatory terms. In the case of digital platforms, however, is there an essential facility and if so, what is it? It is usually the bottleneck facility that cannot be replicated economically. But, as noted earlier, it is more likely to be network effects that protect a digital platform than economic barriers to entry.

Three Criteria Test – challenged but still useful

Digital platform markets have a number of characteristics that are fundamentally different from the ones for which the Three Criteria Test was developed. Most importantly, platforms

are subject to network effects that can cause a market to “tip” towards a single supplier, but that may not give the same level of protection from competition as economic barriers to entry if consumer preferences can tip rapidly towards an alternative.

These network effects run through all of three criteria. A prospective regulator may, therefore, have to adapt the test to the dynamics of digital platforms and consider new ways of assessing each criterion.

Nevertheless the tools exist to make such a judgement and so any decision to impose *ex ante* regulation can and should be based on a rational economic assessment, not a political or emotional response the immediate zeitgeist.

ⁱ ‘What if large tech firms were regulated like sewage companies?’ The Economist 23 September 2017.

ⁱⁱ See Reillier and Reillier (2017) *Platform Strategy* p.6 for a discussion of the difference between linear and platform businesses.

ⁱⁱⁱ See OECD (2018) *Implications of E-Commerce for Competition Policy – Background Note 4* May 2018

^{iv} European Commission Competition Case At.39740 Google Search (Shopping) 27 June 2017

