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KEY POINTS OF THE HEARING ON DISRUPTIVE INNOVATION

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This executive summary by the OECD Secretariat contains the key findings from the hearing discussion held during the 123rd meeting of the OECD Competition Committee on 16-18 June 2015.

More documents related to this discussion can be found at www.oecd.org/daf/competition/disruptive-innovations-and-competition.htm.

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KEY POINTS OF THE HEARING ON DISRUPTIVE INNOVATION

By the Secretariat

On 16 June 2015, the OECD Competition Committee held a Hearing on Disruptive Innovation (“Hearing”). The purpose of the Hearing was to discuss competition policy responses to new technologies or business models that have the potential of profoundly disrupting existing industries.

Introducing the topic, Chairman Jenny indicated that the Hearing will focus on disruptive innovations, a topic that not only captured the attention of competition law and policy community, but of also of many other economic policy communities. The Hearing focussed on the “disruptive” part of innovation and covered (i) the definition of disruptive innovations, (ii) the specific challenges that the innovation may raise and the suitability of the competition law toolbox to deal with cases involving disruptive innovations.

Three external experts were invited to contribute to the discussion: John Fingleton from Fingleton Associates, Prof. Daniel Crane from the University of Michigan and Ms Salle Yoo General Counsel at Uber. Three jurisdictions (the United States, the European Union and the United Kingdom) expressed a particularly strong interest in the topic and shared some initial experiences in this area at the Hearing.

The purpose of this document is to summarise the main points raised during the Hearing by panellists and delegations, with special focus on the following aspects:

- what do we mean by “disruptive innovation” and how is disruptive innovation relevant for competition law and policy;
- to what extent disruptions affect regulation and how regulation reacts to disruptions;
- the role competition authorities when dealing with disruptive innovation cases and the challenges they face;
- the main lessons learned so far in disruptive innovation cases.

1. Definition of disruptive innovation and links to competition

There is no exact definition of disruptive innovation. However, based on the Hearing discussion two main features seem to be relevant: 1) disruptive innovations have the potential to drastically alter markets and their functioning; and 2) they not only involve a new product or process, but can also involve the emergence of a new business model. Some authors, however, have adopted a narrower definition and focussed only on disruptive technologies to the exclusion of disruptive models.

The Hearing did not reveal a single view of what disruptive innovations are. Nevertheless, participants noted the following:

- Disruption can come either from an existing firm or from a new market entrant.
- Disruption generally occurs on “large” markets which are dominated by entrenched and often inefficient incumbents.
- Disruptors scale up very quickly due to the fact that their services and products are mainly provided through the Internet or mobile technologies.

- Disruptors offer customers new ways to satisfy an unmet (e.g. by introducing a new product) or poorly met (e.g. by introducing a new distribution channel) demand.
- Disruptions generally bring substantial consumer benefit through enhanced competition.
- Disruptions challenge - and sometimes bypass - existing products and business models.
- Disruptions threaten incumbent firms and business models by reducing or destroying their market shares.
- Disruptions not only raise challenge for firms, business models and products, but also for regulators and enforcement agencies.

2. Regulation and disruptive innovations

Disruptive innovations can significantly affect existing regulation. Three scenarios can be envisaged:

- a) *Procompetitive effects of innovations.* The most desired outcome from a competition law perspective is that the innovation allows liberalising markets or some parts of them by bypassing the regulation that hindered competition.
- b) *Review of the existing framework due to the presence of innovators.* A typical feature of disruptive innovations is that new products or technologies do not necessarily fit with the existing regulatory framework. This can create a tension between incumbents and disruptors, and challenge regulators to modify of the existing regulatory framework to take into account of the new products of services. Existing regulations could block innovations to protect existing products and business models. Disruptors will argue that they are not subject to the existing regulatory framework, while incumbents will require regulators to ensure that innovators meet the same standards as the incumbents as a matter of regulatory fairness.
- c) *Anti-competitive effects from disruptive innovations.* If incumbents are successful in convincing the legislator or the regulator to toughen the existing regulatory framework with the aim of making it more difficult or impossible for new products or business models to comply, competition will be suffering. The newly adopted framework could result in a regulation which eliminates entry of innovators or makes it especially difficult to enter the market.

Two specific cases were presented at the Hearing to demonstrate the relationship between innovation and regulatory capture. The first case concerned the regulatory reactions in the different US states to the emergence of a new, direct distribution model of vehicles (Tesla). The second case showed what regulatory obstacles a disruptor might face while attempting to introduce a new product in a highly regulated market (Uber). Several lessons can be learned from the examples of Tesla and Uber:

- Regulators should carefully evaluate whether the existing regulatory framework could be adapted to allow the new business model to develop. Regulators and law makers *must strike a balance* between promoting legitimate policy objectives (e.g. consumer protection, health, environmental and safety requirements) and adopting measures that serve only the interest of incumbents.
- Sometimes the disruptors lobby regulators to create a specific regulatory system which recognises the new business model and increase its credibility vis-à-vis consumers. In these cases, regulators should *recognise the need for a specific regulatory framework* which is flexible enough to allow new forms of competition, but at the same time addresses all the relevant public policy considerations (e.g. consumer protection and privacy aspects, safety requirements, taxation).

- Creating either a new or a modified regulatory framework to allow for disruptive innovations is *especially difficult in a fragmented regulatory setting* (like in federal states or where regulatory powers are spread at local level).
- *Self-regulatory systems* of new business models can operate as substitutes for public regulation. This raises the question of whether self-regulating systems can be a sufficient substitute of external regulation and whether they could provide an effective response to consumer protection and safety concerns that new business models can sometimes raise.

3. The role of competition authorities

Disruptive innovations affect how markets work and depending on the reactions of the incumbent market players they might require the intervention of competition authorities either through their enforcement powers (if genuine competition is distorted) or their advocacy toolbox (if competition law enforcement is either not available or insufficient).

3.1 Enforcement activity

3.1.1 Reaction of the incumbent

The response of incumbents to disruptions could vary significantly depending on the jurisdictions and/or the sectors concerned. The following scenarios can be envisaged which could influence the potential actions and the intensity of the competition authorities' intervention:

- a) *Innovation and competition.* The first possible reaction is for incumbents to start competing with the new product/model. This which force incumbent firms to innovate with great benefits for the whole marketplace. The outcome could be the emergence of more products, better quality products, lower prices and greater choice for consumers. This scenario is the preferred outcome from a competition law perspective and no intervention by the competition authority is required.
- b) *Adaptation or acquisition.* The incumbent might also decide to cooperate with the new entrant or to acquire the innovative technology. In case of an acquisition, competition authorities might play a role in evaluating the pro- and anti-competitive effects of the acquisition if the transaction is reportable under merger control rules. The impact on competition of this scenario is less clear and has to be assessed on a case by case basis.
- c) *Defensive/exclusionary actions.* The third scenario is the less pro-competitive and arises when incumbents take defensive actions, which can take two forms: 1) actions pursuant the existing regulation or 2) anti-competitive behaviour on the market.
 - *Actions taken pursuant to regulatory measures.* The first category of defensive actions aims at ensuring compliance by the disruptor with the provisions of existing regulation which generally does not consider (and therefore may disadvantage) the new entrant. Actions encouraged or required by regulatory measures can be immune from competition law enforcement. For instance in the case of Tesla, antitrust enforcement challenge was not available to attack the anti-competitive state regulations due to state action doctrine in the United States.
 - *Actions that may require the intervention of competition authorities.* The second category of defensive actions involves independent behaviours of the incumbent to restrict market access to the new product/technology. These behaviour could fall under the application of competition law (e.g. if the incumbent puts into practice exclusionary/discriminatory practices), and therefore, trigger enforcement actions by the competition authority. Although traditional competition enforcement tools are highly relevant in these situations, they can

raise challenges and uncertainties as to what extent they could be applied in markets where a disruption has taken place.

3.1.2 Enforcement challenges

The Hearing revealed examples of enforcement challenges that could arise in certain areas of competition law enforcement when markets are disrupted by new products or business models.

- *Challenges in defining the relevant markets.* One significant challenge that competition agencies may face is the definition of the relevant product and geographic markets when new products come in the market. Difficulties arise mainly from the fact that competition agencies may not be equipped to undertake a complex analysis in establishing the relevant markets by taking into consideration fast-moving characteristics of these markets/products, while also evaluating the current eco-systems in which the companies concerned operate. In these cases, competition agencies should assess if traditional market definition tools (e.g. the SSNIP test) may lead to overly narrow markets and may ignore the competitive pressure coming from disruptive products and services from outside the relevant markets.
- *Challenges in evaluating the competitive effects of online platforms.* Due to the prominent increase of online platforms, online transactions and online search options, traditional assessment methods may need revisiting as new competition issues are getting into the radar screen of competition agencies. For example disruptive technologies have affected traditional merger control and led merging parties to raise the “...but there’s Amazon” defence in retail markets or the “...but there is Google” defence in newspaper and local radio markets in many jurisdictions. According to this defence, online disruptors are exerting such a huge competitive pressure on traditional industries that parties argue to clear (the 3-2 or 2-1) transactions that will be presumably otherwise prohibited within a framework of a traditional merger control review. Similarly, vertical online agreements have also become a very current issue which can be evidenced by the fact that a lot of competition authorities have recently investigated most favoured nation clauses (“MFN”) in the online hotel bookings sector.

3.2 Advocacy activity

Enforcement may not always be available to agencies and even when it is, competition authorities may still face challenges if they want to apply effectively traditional tools in markets where competition was disrupted by the entry of new technologies or new business models. In these cases, advocacy can play a very important role.

3.2.1 Points on advocacy and disruptive innovation for competition agencies

- *Need for cross-border co-operation in the field of advocacy.* Disruptions may have cross-country and cross-market effects which require competition authorities to co-ordinate their advocacy efforts and share their experiences and expertise on an international level.
- *Need for a forward-looking approach.* As disruptions can occur very swiftly, early understanding on the economic characteristics that may disrupt markets will be very beneficial for competition authorities (e.g. by closely auditing and monitoring markets, launching market studies, seeking early discussions with disruptors).
- *Importance to contribute to an effective regulatory framework.* When regulators intend to respond to the appearance of new products/business models by adopting a new specific regulatory framework, competition agencies can play an important role in ensuring that the new framework is pro-competitive while at the same time it achieves the other legitimate policy goals underpinning the regulatory framework.

3.2.2 Challenges faced by competition authorities in the field of advocacy

Challenges for competition authorities do not only arise in relation to enforcement, but also with regards to their advocacy role.

- *Difficulties in reacting swiftly.* Disruptions may bring radical and generally unforeseen changes to the market requiring quick reactions from competition authorities. Advocacy can be effective only if timely.
- *Difficulties in finding the most effective way to advocate.* It is very important for a competition agency to find the most effective way to address the possible anti-competitive consequences of the emergence of new technologies or new business models. Advocacy measures can take many different forms, ranging from interventions (e.g. *amicus curiae* briefs) in ongoing litigation, formal advices to legislators/regulators, to workshops with academics, policy makers, and industry participants. It is important that agency can identify the most effective ones on a case by case basis.
- *Difficulties in striking the right balance between various policy interests.* Competition authorities may be reluctant to argue in favour of innovations where there is a risk that pro-competitive disruptions could also have a negative effect on consumer protection. Striking the right balance between pro-competitive measures and consumer protection can be especially challenging to multi-functional agencies which are entrusted with enforcing competition law and consumer protection at the same time.

4. Conclusions and future work

Taking into account the experiences on disruptive innovations discussed in the Competition Committee, the following key points emerge:

- The appearance of *disruptive innovations may raise a variety of policy considerations* as these phenomena may involve privacy, consumer protection, competition law and policy, taxation and labour issues requiring a complex policy approach to address them.
- Many new/disruptive business models do not fit into existing regulatory frameworks and this may *call for the adoption of new and flexible regulatory frameworks* to cover these new forms of competition. Competition agencies can play an important role in advising regulators in this process and allow pro-competitive reforms across markets and sometimes across borders.
- The *fragmentation of the regulatory framework* (either on an interstate or a local level) could result in 1) obstacles for disruptors to enter into the market and 2) a challenge for the competition authorities' advocacy efforts in a favour of pro-competitive regulatory regimes.
- The *traditional competition law enforcement concepts may not be applicable* to markets where a disruptive innovation has taken place. A policy question arises if the traditional competition law toolbox is appropriate for enforcement purposes when new competition issues arise due to the emergence of a disruptive innovator.
- Because of the challenges in the application of the traditional competition law toolbox and the cross-border nature of many innovative disruptions, the *advocacy activity of competition authorities plays a very important role.*
- The rapid growth of these business models warrants further study and discussion. Agencies should share their experiences and expertise with each other.