Kluwer Competition Law Blog

# Is Big Bad? Where the Economy Takes Over from Lawmakers – A Law and Economics Analysis of Regulating Amazon.com

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Lawmakers and *Amazon.com* are involved in a constant cat-and-mouse game. *Amazon.com* is the big winner when consumers and businesses extensively use its digital ecosystem. As a reaction, lawmakers regulate big tech companies to protect end users and business users. This blog post argues that these regulations are not always effective and that their application is often at the expense of social welfare. Additionally, it argues that *Amazon.com* becoming big is no reason to panic. After all, history has repeatedly shown that customers switch to competitors when they are no longer satisfied with the goods and services of a supplier, or when suppliers do not innovate quickly enough.

**The concept of relevant market applied to *Amazon.com***

One of the objectives behind regulating market power in the integrated market of the European Union is economic efficiency. From an economic point of view, efficiency requires that price equals marginal cost. The economy is not efficient if the output is kept artificially low, allowing a price that is higher than the marginal cost to be charged. In this case, part of the welfare created in the production process is lost ('*dead weight loss*'). The prohibition on the abuse of dominant position in Article 102 TFEU seeks to prevent such an inefficient situation. Yet the prohibition is not comprehensive. More specifically, the application of the prohibition is based on the concept of "*relevant market*", which is not appropriate to apply to digital ecosystems.

*Amazon.com* is a digital ecosystem of approximately 40 subsidiaries and third parties offering various goods and services that can broadly be divided into retail and cloud services. These goods and services are offered separately, but some are offered in a bundle, called *Amazon Prime*. An *Amazon Prime* subscription gives you access to inter alia, fast and free delivery, video streaming services, music streaming services, online video games, access to e-books, cloud storage, etc.

Indeed because of the wide range of goods and services supplied, *Amazon.com* is active in various overlapping relevant markets. *Amazon.com* does not hold a dominant position in every market in which it operates. However, if *Amazon.com* has a dominant position in relevant market x, it can leverage that dominant position in another relevant market *y*, in which it does not have a dominant position.

To illustrate this, *Amazon.com* can be juxtaposed with digital platforms like *Spotify* and *Netflix*. These firms are merely active in the market for streaming services for music and video respectively. Whereas *Amazon.com* offers both these services to its *Amazon Prime* subscribers in combination with several other services for a single price. Goods and services supplied in a digital ecosystem are complementary and interconnected. Therefore, *Amazon.com* is active in multiple product markets.

Digital ecosystems grow exponentially and spill over to different markets. Given that the value of combined goods and services is more important than the sum of the stand-alone values of each individual good or service, the components of such a bundle cannot be assessed separately. There are two ways to apply Article 102 TFEU to *Amazon.com*. The first is to connect the relevant market in which *Amazon.com* has a dominant position to the market in which that dominant position is leveraged (Jacobides & Lianos, 2021). The second way is to determine the relevant market on an ecosystem basis (Jenny, 2021). This method allows assessing Amazon's overall goods and services supplies in one bundle rather than assessing each good or service individually. The concept of a relevant market does not allow for either of these two options to be performed. This makes it hard for competition authorities to consider the dynamics between the variety of goods and services offered by *Amazon.com*.

## The Reaction of the European Commission: draft revised Market Definition Notice

On 8 November 2022, the European Commission launched a draft revised Market Definition Notice to accommodate the uncertain application of Article 102 TFEU to digital ecosystems, like *Amazon.com*. The Notice explains recent case law and developments in the market which should allow us to interpret and apply the concept of the relevant market in a way that responds to the development of recent years.

According to the Notice, a bundle of goods and services provided by a digital ecosystem can constitute a relevant market on its own (Marthan, Kuhn, Preti, & Liu, 2022). *Amazon.com* seeks to differentiate itself from other digital ecosystems by offering a bundle, regarding the composition of this bundle, rather than offering the same bundle at a competitive price. Potential users choose among different digital ecosystems based on the combination of goods and services offered. This means that digital ecosystems compete with respect to the bundle of goods and services they supply, irrespective of whether there is an overlap in the combination of services catered for users or not. This is not considered if the relevant market for digital ecosystems is defined on the basis of a single bundle with a well-defined combination of goods and services.

## *Amazon.com* as a super platform ecosystem

The establishment of digital ecosystems caused a change in the organization of the economy, according to Jacobides, Sundararajan, & Van Alstyne. This change had an impact as relevant as the Industrial Revolution. Back then, industrial firms were driven by economies of scale on the supply side. In contrast, the success of digital ecosystems lies within economies of scale by demand. The reason for this consists of network effects in digital ecosystems. The more users a digital ecosystem has, the more valuable it becomes to both current and potential users. To the extent possible, digital ecosystems adapt the supply of goods and services to the preferences of their

users.

The goods and services are supplied by multiple platforms brought together in one digital ecosystem. For this purpose, not only do numerous subsidiaries work together, but *Amazon.com* also collaborates with third parties to make this happen. This is the most complex type of digital ecosystem and is called a super platform ecosystem. All goods and services are highly interconnected and form a complementary unit. Therefore, *Amazon.com* has evolved into a one-stop-shop ecosystem with a wide range of goods and services.

This sets *Amazon.com* apart from digital platforms that focus on one particular service, for example, the business model of bol.com focuses only on retail. It follows that *Amazon.com*'s competitors are represented by other super platform ecosystems, like *Apple,* instead of digital platforms like *Netflix* or *Spotify*. Whereas a subscription to *Netflix* only gives access to video streaming services, a subscription to *Apple one* gives access to a bundle of goods and services, such as *Apple Music, Apple TV+, iCloud+* and *Apple Arcade*.

Despite the different compositions of the bundles, *Amazon.com* and *Apple* compete to sell their bundle of goods and services to customers. If customers are interested in a subscription to a bundle of goods and services, they let their choice depend on the composition of the bundle. There is a certain overlap between *Amazon Prime* and *Apple One*, but ultimately customers choose the bundle that most closely matches their preferences. Given the financial advantage offered by bundles as well as the interconnectedness of the goods and services, customers interested in multiple goods and services will not revert to several individual subscriptions.

**Digital Markets Act**

The Digital Markets Act (DMA) is meant to complement competition law in the context of the digital economy because classical competition law rules were not suitable for this purpose. Using qualitative criteria complemented by quantitative thresholds, the DMA tackles certain issues that are not addressed through competition law. The DMA imposes *ex-ante* obligations and prohibitions upon *gatekeepers of core platform services*, without any efficiency-based exemption thereto.

The DMA uses a list of activities, "*core platform services*", with characteristics that an undertaking can abuse to affect the contestability and fairness of the market. However, that risk only exists if the provider of core platform services meets three objective criteria, which allows the provider to be designated as a "*gatekeeper*". A gatekeeper establishes a gateway for users to those core platform services with at least a foreseeable significant impact in the internal market and an entrenched and durable position thereto. Additionally, the DMA uses three quantitative thresholds that, when met, operate a rebuttable presumption in favour of the Commission to designate the provider as a gatekeeper. The DMA only tackles gatekeepers of core platform services.

*Amazon.com* offers two important core platform services. Firstly, *Amazon.com* offers online intermediation services to its third-party suppliers. Secondly, *Amazon Web Services* falls within the scope of cloud computing services. Not surprisingly, *Amazon.com* exceeds by far the quantitative thresholds to be designated as a gatekeeper.

Although the Commission can update the list of core platform services, it will take some effort to

keep the list up to date, given that digital ecosystems develop rapidly.

Gatekeepers are subordinated to various prohibitions and obligations in order to ensure fairness and protect market contestability. These prohibitions and obligations are concrete and clearly based on previous antitrust cases in which *Amazon.com* – among others – was involved. [1]

The prohibitions and obligations only apply to gatekeepers with respect to individual core platform services for which they are designated as a gatekeeper. Again, it is difficult to distinguish core platform services provided by a gatekeeper from the rest of its interconnected services. This is particularly important with regard to services for which the provider leverages its power as a gatekeeper of other core platform services.

A provider of core platform services that meets the quantitative thresholds in Article 3 of the DMA is allowed to rebut the presumption that the provider has a significant impact on the internal market by proving that it does not fulfil the requirements to qualify as a gatekeeper. For this, the argument of efficiency is not allowed. From a welfare perspective, this means that the DMA protects the welfare of *Amazon.com*'s business users at the expense of the consumer welfare of end users. Certain practices of *Amazon.com* that increase efficiency, but are detrimental to its business users, may still benefit consumer welfare. The EU legislator thus opted for Pareto improvement – *i.e.* allocation of resources that harms no one and benefits at least one person – instead of a Kaldor-Hicks improvement – *i.e.* reallocation of resources where those who are better off outweigh the harm for those who are worse off. This may limit innovation to the extent that innovation would come at the expense of certain stakeholders and eventually might negatively impact social welfare.

**Market strategies of digital ecosystems**

The quickly developing digital economy challenges lawmakers to adopt appropriate rules to regulate market power. Two important market strategies are product differentiation and economies of scale, as indicated by Bentata & Bouzou. The efficacy of these strategies depends on consumer preferences. Product differentiation – *i.e.* customizing products to certain preferences – only works if consumers are willing to pay extra for it. Economies of scale – *i.e.* a decrease in costs by increasing the output – require that consumers prefer mass production at a low price. Due to the network effects in a digital ecosystem, economies of scale occur in each digital ecosystem of the big tech companies. As this is peculiar to a digital ecosystem, economies of scale cannot be used as a strategy in this specific context. The digital ecosystems will have to differentiate the bundles of goods and services to win over the customer. The combination of these two strategies is particularly beneficial for customers because it results in both specialized goods and services at a relatively low price.

*Amazon.com* has a strong market position because of consumer choice and network effects. This does not alter the fact that *Amazon.com* is still subject to competition. Indeed, *Amazon.com* can rely on existing infrastructure and clientele for the development and marketing of additional services. Consequently, the entry cost for *Amazon.com* to provide a new service and add the bundle to it, is lower than the entry cost for a service provider starting from scratch. This illustrates that *Amazon.com*'s market power should only be assessed in comparison to digital ecosystems instead of suppliers of substitutive services from *Amazon.com*'s bundle. Indeed, they target different customers. Compared to other digital ecosystems like *Apple*, *Amazon.com*'s market power is less

evident.

**Theory of Schumpeter: creative disruption results in innovation**

In a condition of perfect competition, the price equals the marginal cost. A disequilibrium of the price and the marginal cost results from changes in the production process, according to Schumpeter's theory of economic development. In other words, a "*creative disruption*' of the market equilibrium, in which the price and the marginal cost are equal, results in "*Schumpeterian innovation"*. To innovate, suppliers creatively recompose resources and change elements in the economic system to create new combinations of goods and services. The profit from such an innovative combination depends on the conservation of other suppliers and the speed by which they imitate the innovation of successful inventors. Also, the development of the price level depends on the speed with which other suppliers react to innovation.

Combining services in a bundle and supplying them via a digital ecosystem is an organizational innovation. Different digital ecosystems use different technologies and a different combination of resources to compose the ecosystem. As for the practical application of these formulas, chances for success on the market are different for each digital ecosystem (*"differential survival"*). To keep up with other digital ecosystems and gain profit, *Amazon.com* must innovate continuously. Network effects in a digital ecosystem create a winner-takes-it-all dynamic, which makes it hard to compete with a successful digital ecosystem, however not impossible.

There is a constant need for innovation in the digital economy, automatically creating competition between operators of digital ecosystems. According to Schumpeter, a threat of competition is sufficient to incentivize *Amazon.com* to innovate continuously to differentiate its products and services.

**History repeats itself**

The introduction of new commodities in the production process and new types of economic organization is what drives the economy, according to Schumpeter. Lawmakers still see a threat in network effects, economies of scale and economies of scope that come along with *Amazon.com*'s organizational innovation. However, history shows that there is some truth in Schumpeter's *creative disruption* theory.

Several undertakings used to occupy a dominant position because of the innovation they brought to the economy. Later, these companies were replaced by other companies that came up with new products, services or innovative business models.

The case of *Amazon.com* is similar to the case of the *Great Atlantic and Pacific Tea Company* (A&P). A&P brought organizational innovation to the retail market with the introduction of the supermarket chain. This model aimed to open standardized supermarkets, characterized by a wide range of grocery products and low prices. Contrary to local traders who only had a limited but specialized range of products available and usually charged high prices. Because grocery shopping became less time-consuming and supermarket chains charged lower prices, consumers choose to shop at A&P, at the expense of local retailers. Notice the similar impact of *Amazon.com*'s

organizational innovation as a digital ecosystem on digital platforms offering a single service.

At the time, A&P faced the same charges as *Amazon.com* faces today, according to Bourne. As Schumpeter argues in his *theory of creative disruption,* A&P was later competed out of the market due to organizational innovation. The model of supermarket chains had to give in to shopping centres that house several small stores and warehouses also offering items other than groceries. Time changed consumer preferences. As soon as users of *Amazon.com*, or any other digital ecosystem, are no longer satisfied, it is likely that they will leave *Amazon.com.*

The investment in research and development *Amazon.com* makes is to compete with existing digital ecosystems, but also to cope with the threat of potential newcomers with a different approach. The market mechanism supports innovation. Entrepreneurs who do not innovate will lose market power and may even be forced out of the market eventually.

**Big tech under pressure**

Recently, GAFAM's big tech companies took a hard hit in the stock market. Although the last quarter of the year is usually a very promising one for *Amazon.com*, revenue forecasts for that period were disappointing. This had implications for *Amazon.com*'s value in the stock market.

Around the world, customers face a post-pandemic crisis. This has a direct influence on customer preferences. The shift in preferences requires big tech companies to review their business models and adjust as needed. *Amazon.com* and others will have to be innovative, creative and flexible to cope with changing consumer preferences. If not, those digital ecosystems will have to give in to their competitors' Schumpeterian innovation.

**Conclusions**

This blog post started with the observation that the concept of a relevant market is not applicable to digital ecosystems like *Amazon.com*. The bundle of goods and services falls within the scope of various overlapping relevant markets. The draft revised Market Definition Notice tries to accommodate the application of Article 102 TFEU to digital ecosystems by defining a relevant market for a specific bundle of goods and services. This interpretation still does not adequately addresses competition between digital ecosystems.

The DMA complements competition law but is also blind to the leverage *Amazon.com* has by offering services in one bundle. Nevertheless, the market mechanism safeguards the balance between powerful digital ecosystems like *Amazon.com* and its users. *Amazon.com* can only maintain market power if it continues to innovate and satisfies its users' preferences.

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[1] Case AT.40153 E-book MFN's and related matters (Amazon) and Case AT.40462 Amazon Marketplace.

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