

How to regulate on-line platforms in Europe?

Winston Maxwell, associate attorney at Hogan Lovells, and **Thierry Pénard**, professor of economics at the University of Rennes I

For: In Jean-Pierre Dardayrol (ed.) *The European digital union* [special issue of *Réalités Industrielles*, August 2016

Summary:

The success of digital platforms, which play a role, both constructive and disruptive, in the economy, has spawned societal, political and economic concerns. The question of regulating them is on the agenda in Europe and France. Though recognizing the problems stemming from powerful organizations like Google, Amazon or Facebook, this article shows that regulating these platforms would encounter several difficulties, economic as well as legal. Given the digital marketplace's instability and its strong potential for technological and social innovations, the cost and inefficiency of regulations of this sort are pointed out. A pragmatic approach based on existing law is preferable as a remedy for the problems caused by digital platforms, especially in emerging markets. The European Commission has advocated this cautious approach, and the OECD has formulated it as a methodology in *Better Regulation in Europe*.

Overwhelmingly endorsed by cybernauts, digital platforms, such as AirBnB, Blablacar, Facebook or Google, now play an ever more leading role in all businesses with no exceptions (culture, tourism, finance, retail trade, services, etc.). Their success has effects, as constructive as disruptive, that are a cause of worry politically, economically and societally.¹

The major concerns focus on these platforms' economic weight and the danger of anticompetitive practices (abusive clauses in contracts, exclusivity, discrimination and so forth) toward client firms or toward other service- or content-providers. Another cause of apprehension stems from the platforms' relations with cybernauts and their use of personal data (lack of transparency and accountability, excessive data collection, etc.). Broader concerns have also been voiced about the damage to society: the diffusion of unlawful contents, noncompliance with fiscal regulations or infringements on digital sovereignty (when the platforms are of American origin).

These preoccupations are clearly illustrated by the proceedings opened by the European Commission (henceforth EC) against Google Shopping in 2010 and, more recently, Android, the mobile phone operating system. Google's critics have repeatedly pointed to the slow pace of proceedings and the inadequacy of competition law for putting an end to the incriminated practices.

This is the context in France and Europe where the idea of adopting specific regulations for digital platforms has taken shape. According to the communication from the EC (6/5/2015), "*Some on-line platforms have evolved to become players competing in many sectors of the economy, and the way they use their market power raises a number of issues that warrant further analysis beyond the application of competition law in specific cases.*"

As part of its strategy for a Digital Single Market, the EC (25/5/2016) issued a fact sheet for a "*targeted approach to on-line platforms*", which combines regulatory obligations, self-regulation and co-regulation. Without waiting for the conclusion of this European debate, the French

¹ Article translated from French by Noal Mellott (Omaha Beach, France). References and points of information have been updated for this translation.

act “for a digital republic” has been passed with regulations and new obligations for on-line platforms.² These platforms now have to provide users with clear, transparent, reliable information about the general conditions for using their services, about their methods of listing and ranking products, and about the relations (contracts, financial holdings) between a platform and the services it lists.

We would like to examine the cogency of regulating on-line platforms. Without disputing the quite real problems stemming from platforms as strong as Google, Amazon or Facebook, we shall show that a specific regulation would occasion problems, both economic and legal. Solutions, better adapted to the technological and economic characteristics of digital markets, are then proposed in line with the “Better Regulation” methodology advocated by the EC (13/5/2015) and OECD.

Platforms in an economic perspective

The first obstacle to a specific regulation about digital platforms: there is no economic definition of what is to be regulated. Economists define digital platforms by the services provided (information, searches, communications, transactions) as much as by business models (market shares or advertising) or the resulting ecosystems. Given this potentially vast range of services and business models, it is hard to formulate clear guidelines for regulating digital platforms as a legal category. The EC (25/5/2016) has listed five main categories of on-line platforms: e-businesses, ecosystems of mobile applications, search engines, social media and on-line advertising.

The common denominator is that these platforms are multisided: they bring into relation several groups of users who are unable, alone or mutually, to “capture” the value of their interactions. Following up on Rochet and Tirole (2003, 2006), the theory of two-sided markets has tried to describe platforms’ strategies and their economic impact (BOUDREAU & HAGIU 2010; EVANS & SCHMALENSEE 2007; CHOUDARY, PARKER & VAN ALSTYNE 2016). But these studies do not propose an operational definition of what is (or is not) a digital platform.

Owing to the lack of clear, objective criteria for identifying and defining platforms, ambiguity arises about the sectors and firms likely to fall inside the scope of a regulation targeting platforms. The EC (25/5/2016, p.45) has pointed out this problem.

A second obstacle has to do with the markets where digital platforms are active (SHAPIRO & VARIAN 1998; MALIN & PÉNARD 2010). These markets have economic characteristics that both hinder competition (by favoring the concentration of existing businesses) and stimulate the arrival of new businesses or the renewal of existing businesses.

First of all, the firms (in particular platforms) on these markets have high fixed costs and rather low marginal costs for the production or distribution of services and contents. This generates economies of scale and leads to a concentration on the supply side. These markets also have considerable, direct and indirect, network effects: the utility or advantages of a service supplied by a platform are directly and/or indirectly influenced by the (actual or potential) number of those who use the service. These network effects are larger on platforms providing communication services (social media, such as Facebook or Snapchat) than on search engine platforms. The combination of economies of scale and network effects sets off a positive feedback loop that accelerates the platform’s diffusion. The more users a platform has, the more new ones it is going to attract. A platform’s success (or survival) depends, therefore, on its capacity for attracting a critical mass (threshold) of users. As a consequence, the platform’s on-line activities are very risky but, too, tantalizing, since the winner takes all (of the market).

² Lemaire Act on a Digital Republic: Loi n° 2016-1321 du 7 octobre 2016 pour une République numérique, *Journal officielle*, 235, 8 October 2016. Available at: https://www.legifrance.gouv.fr/affichTexte.do;jsessionid=93D0CE3168F6783F5F64419E5328D436.tpdila14v_1?cidTexte=JORFTEXT000033202746&categorieLien=idea

Finally, the buoyant pace of innovations is another characteristic of digital markets. Owing to it, newcomers enter the market more easily; and market shares can soon be redistributed. A firm with a strong position on a digital market never feels protected. It must constantly innovate to keep its position and make innovations faster than competitors. Competition is “for” — not “inside” — the market (SHELANSKI 2013). This last characteristic, by itself, offers a powerful means for regulating e-markets.

Citing network effects and the interdependence between different “sides” of the market, economists have insisted on the complexity and risks of regulations targeting platforms. Given that platforms are multi-sided, a regulation targeting a single side of the market might turn out to be inappropriate and set off counterproductive or uncontrolled effects on the other sides of the market (EVANS & SCHMALENSEE 2014). When intervening, regulatory authorities take the risk of bringing innovation to a standstill; and they risk halting value creation, which would be impossible outside these platforms.

What approach to adopt to “better regulate” platforms?

In line with the Better Regulation methodology advocated by the OECD (2011, 2012) and the EC, the need for regulation has to be evaluated in relation, first of all, to a well-defined objective (usually to correct a proven market anomaly) and then to a “*baseline scenario*” for projecting how this anomaly is likely to evolve if regulatory authorities abstain from intervening. This scenario must not be static but, on the contrary, take into account the probable evolution of both the market and regulatory environment in the coming years (RENDA *et al.* 2013).

In the case of a proposal for a specific regulation on platforms, the first step will, therefore, be to clearly specify the failures on the market under question: abuse of dominant position, negative externalities, information asymmetry, etc. A baseline scenario will then describe how these failures are addressed using current regulations and laws (antitrust legislation, EU regulations on protecting personal data, consumer protection laws, class action suits). If nonbinding legal arrangements (charters, codes of conduct or recommendations) exist, their eventual application must also be brought under consideration.

Once the baseline scenario has been established, its efficiency must be compared with that of the various proposals for regulation. If the problem is an abuse of dominant position by platforms in relation to businesses (for instance, hotels), it is to be evaluated in the baseline scenario and in a scenario providing for a specific regulation. If, for example, the problem is evaluated at ten in the baseline scenario (no regulation) but at eight in the scenario of a specific regulation, the regulation’s hoped-for benefit is two (ten minus eight).

Each regulatory option’s costs (direct and indirect) must then be assessed in relation to the baseline scenario. Direct costs include the costs of implementing the new regulatory framework (for human resources, additional funds, setting up a new administrative agency) as well as the costs for the firms affected by the new regulation (once again, for human resources, fees for outside services, such as lawyers, etc.). Indirect costs include the impact on innovation, fundamental rights, competition or the openness of the Internet. They are hard to assess quantitatively, but they must, at least, be evaluated qualitatively.

At the end of this process, the option bearing the highest net benefit (benefits minus costs) is to be preferred. However an analysis of this sort is not simple to make in the case of on-line markets, since the latter are economically volatile and technologically unpredictable. Regulating digital markets is prone to error and inefficiency. As Shelanski (2013) has explained, the costs stemming from unadapted regulations are much higher than the costs of no intervention (the baseline scenario). In other words, the costs of a Type I error (applying a poorly targeted regulation) will be higher than those of a Type II error (inaction). When in doubt, it is better to not regulate on-line markets, which are changing rapidly.

In 2007, the EC already recognized the unpredictability of emerging markets in its recommendation for regulating electronic communication markets: *“In general, new and emerging markets are unstable, exhibiting uncertainty of supply and demand and fluctuations in market shares. They are characterized by a significant degree of innovation which can lead to abrupt and unexpected changes (as opposed to a natural evolution over time).”*

In compliance with this EU methodology, member states should (in principle) make no haste to regulate the markets where on-line platforms are being installed. However this pragmatic approach to regulation does not always measure up to the political circumstances. In the case of platforms, political actions respond to pressure from citizens and interest groups. This pressure might be motivated by more or less rational fears (SUNSTEIN 2005). To respond to apprehensions, a regulation might be adopted for its symbolic value — what has been called the *“expressive”* (SUNSTEIN 1996) or *“normative”* (SCHULTZ 2008) function of the law. In this case, the regulation’s efficiency is a concomitant criterion. As Sunstein (2005) has shown, several US regulations for protecting the environment were responses to specific spectacular events. The efficiency of such regulations is uncertain, since their costs far exceed their benefits to society.

Institutionally, a regulator, whether a lawmaker or an agency, will prefer action (*i.e.*, regulation) to inaction (*i.e.*, no regulation), since the political benefits of action occur immediately whereas the costs of a poorly adapted regulation become visible only in the middle or long run, usually after the political reckoning date on the regulator’s mind. With respect to on-line platforms, the regulatory authority’s normal attitude will, therefore, be to intervene, since the regulator will not have to face the costs resulting from excessive regulation. On the contrary, a more cautious solution, namely no regulation, would maximize the net benefits for society. The Better Regulation methodology seeks to make sure that merely symbolic arguments or institutional issues do not obfuscate the assessment of a regulation’s efficiency (*i.e.*, net benefits compared with the baseline scenario).

Conclusion

Platforms, such as trade shows and fairs, came into being long ago. Nevertheless, digital platforms stand out owing to their capacity for bringing individuals into relation on a large scale, which augments network effects and value creation via technological, economic and social innovations. The recent trend toward regulating on-line platforms in Europe tends to underestimate the potential of innovations and the problems in working out a legal definition of platforms.

This article has drawn attention to the complexity and costs, direct and indirect, of a specific regulation during the current phase in the growth of on-line markets.

First of all, the target of such a regulation, namely digital platforms, potentially concerns a multitude of services and intermediaries with very little in common apart from their presence on two-sided markets.

Secondly, neither authorities nor economists are capable of mustering evidence of durable market anomalies that are to be blamed on the platforms alone. Aware of these arguments, the EC is starting to advocate a *“problem-based approach”* to regulation instead of targeting platforms as such. For the time being in France, the Competition Authority, CNIL, DGCCRF and courts have managed to apply existing legal rules to settle the problems encountered on platforms like Google or Booking. In fact, the Competition Authority is not calling for a specific regulation of platforms, since it sees itself as fully competent for coping with threats to competition.

In fact, no assessment has been made of the potentially negative effects that a regulation targeting on-line platforms would have on competition and innovation. Till now, this lack of assessment has been justified by the inference: since a platform has a sizeable share of the market on at least one side of the market, it must necessarily be regulated. This argument is moot for several reasons.

First of all, having a large share of a market is not necessarily proof of power in the case of digital markets. This holds, in particular, for platforms with business models that, based on the platform's audience, have low costs to consumers when they switch platforms.

Secondly, the existence of market power or of a dominant position is not a problem as such. What causes a problem is the abusive use of this power; and competition law already provides for that.

Thirdly, the services (such as insurance or payment services) offered via on-line platforms are often already regulated as such.

Finally, the problems cropping up in digital markets are often temporary. A premature intervention might be a cause of high costs and a source of errors. For this reason, the OECD and EC require detailed cost/benefit analyses before considering whether to adopt new regulatory measures. The purpose is to see to it that regulations respond to genuine needs that neither the market nor existing legislation can address. In France, the recently passed Lemaire Act on a Digital Republic, despite the hearings conducted beforehand, does not seem to have followed this approach.

References

BOUDREAU (K.) & HAGIU (A.), "Platform rules: Multi-sided platforms as regulators" in GAWER (A.) (ed.), *Platforms, Markets and Innovation* (Northampton, MA: Edward Elgar, 2010).

CHOUDARY (S.P.), PARKER (G.) & VAN ALSTYNE (M.), *Platform Revolution* (New York: Norton, 2016).

EUROPEAN COMMISSION, "Staff Working Document accompanying the Commission Recommendation on Relevant Product and Service Markets within the electronic communications sector", SEC(2007) 1483/2, 12 November 2007. Available via:
<http://ec.europa.eu/transparency/regdoc/?fuseaction=list&cotelid=2&year=2007&number=1483&version=ALL&language=sv>

EUROPEAN COMMISSION, §3.3.2 in "Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions: A Digital Single Market Strategy for Europe" COM(2015) 192 final, 6 May 2015. Available at:
<http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1447773803386&uri=CELEX:52015DC0192>

EUROPEAN COMMISSION, Staff Working Document, "Better Regulation guidelines" and "Better Regulation toolbox", SWD (2015) final, 19 May 2015. Available respectively via:
<http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1479218042952&uri=CELEX:52015SC0111>

EUROPEAN COMMISSION, "Fact sheet: Digital Single Market – Commission updates EU audiovisual rules and presents targeted approach to on-line platforms", 25 May 2016. Available at:
http://europa.eu/rapid/press-release_MEMO-16-1895_en.htm

EUROPEAN COMMISSION, "Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions: On-line platforms and the Digital Single Market: Opportunities and challenges for Europe", COM(2016) 288 final, 25 May 2016. Available at:
<http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52016DC0288>

EUROPEAN COMMISSION, “Staff working document: On-line platforms” SWD (2016) 172, 25 May 2016. Available via
<http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1479211912342&uri=CELEX:52016SC0172>

EVANS (D.) & SCHMALENSEE (R.), “The industrial organization of two-sided platforms”, *Competition Policy International*, 3(1), 2007.

EVANS (D.S.) & SCHMALENSEE (R.), “The antitrust analysis of multi-sided platform businesses” in BLAIR (R.) & SOKOL (D.) (eds.), *Oxford Handbook on International Antitrust Economics* (Oxford, UK: Oxford University Press, 2014). Available at
http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2185373

MALIN (E.) & PÉNARD (T.), *Économie du numérique et de l’Internet* (Paris: Vuibert, 2010).

OECD, *OECD Council Recommendation on Principles for Internet Policy-Making*; 13 December 2011. Available at
<https://www.oecd.org/internet/ieconomy/49258588.pdf>

OECD, *Recommendation of the Council on Regulatory Policy and Governance*, 22 March 2012. Available via:
<http://www.oecd.org/governance/regulatory-policy/2012-recommendation.htm>

RENDA (A.), SCHREFLER (L.), LUCHETTA (G.) & ZAVATTA (R.), *Assessing the Costs and Benefits of Regulation, Study for the European Commission, Secretariat General*, Brussels, 10 December 2013.

ROCHET (J.C.) & TIROLE (J.), “Platform competition in two-sided markets”, *Journal of the European Economic Association*, 1, pp.990-1029, 2003.

ROCHET (J.C.) & TIROLE (J.), “Two-sided markets: A progress report”, *Rand Journal of Economics*, 37, pp. 645-667, 2006.

SCHULTZ (T.), “Carving up the Internet: Jurisdiction, legal orders, and the private/public international law interface”, *European Journal of International Law*, 19, pp.799-839, 2008.

SHAPIRO (C.) & VARIAN (H.), *Information Rules: A Strategic Guide to the Network Economics* (Boston, MA: Harvard Business School Press, 1998).

SHELANSKI (H.A.), “Information, innovation, and competition policy for the Internet”, *University of Pennsylvania Law Review*, 161, pp.1663-1705, 2013.

SUNSTEIN (C.R.), “On the expressive function of law”, *University of Pennsylvania Law Review*, 144, pp.2021-2053, 1996.

SUNSTEIN (C.R.), *Laws of Fear: Beyond the Precautionary Principle* (Cambridge, UK: Cambridge University Press, 2005).