FRAND IN THE DMA

The quest for a fair price in the digital world

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The European Commission's Digital Markets Act (DMA) will establish a new set of do's and don'ts for so-called gatekeeper platforms, as explained in our previous articles here and here. Two of the obligations relate to the terms and conditions under which designated gatekeepers supply services to other digital service providers. In particular, designated gatekeepers that offer online search services (read – Google) will be required to grant access to their ranking, query, click and view data to other search engine providers on 'fair, reasonable and non-discriminatory' (FRAND) terms. Gatekeepers that offer app stores, search engines and/or social media network services will also be required to provide access to these on FRAND terms.

FRAND IN THEORY

FRAND terms are typically applied in situations where a product is an important input for certain downstream markets (e.g. patents relating to a technology that is essential for an industry standard). In these cases, the supplier of that input may hold a degree of market power. Requiring access on FRAND terms limits the extent to which such suppliers are able to take advantage of this market power in exchange for 'fair' compensation to maintain the incentive to produce the relevant inputs.

However, what constitutes FRAND is not a straightforward economic or legal question. There is some precedent from the application of FRAND principles in other contexts, but the appropriate approach varies depending on the specific nature of the concerns. There is no clearly defined, objective bright-line test. What's clear is that the EC has set a significant challenge for itself. Its own chief competition economist, Pierre Régibeau, recently remarked: "*People who are going to be enforcing the Digital Markets Act: good luck. You're going to have to do a lot of access pricing…*"

In this article, we consider what "fair" and "reasonable" access pricing could mean in the context of the DMA and highlight some of the big implementation challenges that will need to be addressed.

EXEC SUMMARY

The EU Digital Markets Act (DMA) includes a wide range of behavioural and structural remedies applied to digital 'gatekeepers' in an attempt to stem what is perceived to be unfair practices by large Internet platforms. While many of these remedies set out obligations on the gatekeepers with clear 'bright line' tests for compliance, a subset of the remedies require the gatekeepers to trade with other companies on a 'fair, reasonable and non-discriminatory' (FRAND) basis.

In this article we explore how such FRAND obligations could be assessed for compliance, both by the gatekeepers themselves and by regulatory authorities. We find that even in the simplest cases, where existing services will become regulated, there are significant issues in determining whether the terms offered, including pricing, are FRAND compliant. In other areas, where gatekeepers will be obliged to create new products on a FRAND basis, there are significant conceptual issues that need to be addressed before any determination that the products are, or are not, FRAND compliant.

Given the likely resource constraints following the implementation of the DMA, regulatory authorities may not prioritise addressing complex issues such as FRAND compliance. However, gatekeepers will need to put in place processes for determining whether their offers are compliant with the DMA, including whether these offers are fair, reasonable and non-discriminatory. Third parties that feel they're being treated unfairly will also likely start filing complaints fairly swiftly once the DMA comes into force. The EC will therefore need to begin grappling sooner rather than later with the host of complex challenges that FRAND raises.

A FAIR PRICE FOR APP STORE ACCESS?

App stores serve as an important route to market for app developers: without such access, they would reach a much smaller pool of end customers. At the same time, app stores need the content provided by app developers: without such content, the stores would be less attractive to end customers.

The FRAND obligation is intended to address the "*imbalance in bargaining power*" between app stores and developers, which the EC thinks could allow gatekeepers to behave unfairly. The DMA is vague when it comes to exactly the sorts of unfair behaviour it has in mind. However, excessive pricing is likely to be the central concern. Indeed, Apple and Google have come under fire recently over the fees they charge to third-party app developers using their respective stores. Both firms have faced high-profile legal challenges from disgruntled app developers, most notably Epic Games, which has described the 30% commission Apple charges on app store purchases as "exorbitant".

Determining whether a price is excessive is notoriously difficult. While the EC may not be bound by competition law precedent, the approach followed in past excessive-pricing cases is clearly relevant, particularly given that the DMA offers no alternative. Specifically, *United Brands* established a two-limbed test for excessive prices.[1] The first limb (the price-cost test) requires an assessment of whether the dominant firm's profit margin is excessive. The second requires evaluating whether a price is "unfair in itself or in comparison with the prices of competitors". There is no pre-defined set of guidelines on how the United Brands criteria should be applied in practice. Case law is also thin on the ground. Indeed, the EC and national authorities rarely pursued alleged excessive pricing after United Brands. This reflects the significant difficulties and ambiguities in trying to establish whether prices are excessive.

Applying a price-cost test in the context of digital markets presents obvious headaches. Chief among these is the difficulty of coming up with a meaningful definition of cost for products that are part of a wider ecosystem and whose value stems primarily from intangible assets (e.g. brand, research, human capital). Even once the relevant cost base has been established for a gatekeeper, the EC would need to come to a view on what is a reasonable margin to be allowed on top of the cost base to compensate investors for the risks they take. This is especially important in digital markets, which are characterised by high levels of innovation and R&D, and where high returns from successful investments are necessary to offset losses on unprofitable ventures. Regulators will need to properly account for this trade-off when assessing a fair return to ensure future investment.

Even if the EC were to find that the fees charged for app stores were above some reasonable measure of cost, it does not automatically follow that prices are 'unfair' and/or 'unreasonable.' According to United Brands, prices are unfair if they bear "*no reasonable relation to the economic value*".[2] Apple and Google would argue that their ecosystems have created enormous value by giving third parties a platform to develop and distribute new products on a global scale, and that their fees are commensurate with this opportunity. App developers like Epic, on the other hand, have argued that commissions are extortionate and reflective of app stores' market power.

[1] Case 27/76, United Brands v Commission [1978] ECR 207, paragraph 252

[2] Case 27/76, United Brands v Commission [1978] ECR 207, paragraph 250

Clearly, both app stores and app developers, together, play an important role in generating value for consumers. In this context, FRAND could be framed as a question of whether each side is getting a fair share of the pie. It is hard to see, however, how the Commission will judge what is a fair share.

Presumably in recognition of the above challenges, the DMA appears to lean towards a comparator approach: it identifies a number of yardsticks that it would use to assess whether access conditions are fair, including prices charged by other app stores or "related or similar services" and prices charged in different countries. This methodology, while ostensibly more straightforward, still has some fairly fundamental drawbacks. Notably, many of the most relevant comparators may be gatekeepers themselves and hence an inappropriate benchmark from the EC's perspective. Conversely, newer entrants may have relatively low prices because they have not faced the risks that the gatekeepers took in establishing their ecosystems.

FRAND FOR SEARCH ENGINES AND SOCIAL NETWORKING – A LATE ADDITION

The requirement for gatekeepers to give 'business users' access to online search and social networking services on FRAND terms was tagged on to the app stores obligation fairly late in the drafting process. While the EC has set out its reservations with regard to app stores, the DMA doesn't provide any guidance on the concerns it is seeking to address by applying FRAND to business users. In fact, it doesn't even say which users it has in mind.

One category of business user that the DMA might be seeking to support/protect is advertisers. Google's and Meta's strength in digital advertising has been an area of concern for competition authorities.[3] It is possible that the EC primarily had in mind fairness and transparency around non-price terms for advertisers. However, the wording doesn't rule out a pricing dimension, which will likely lead to complaints.

Determining what fair/unfair pricing looks like appears even more problematic than for app stores. Prices for digital ads are set on an individual basis in real time, through a competitive auction mechanism that relies on complex algorithms to rank advertisers' bids. The individual, ad-specific nature of pricing also makes applying a benchmark approach challenging.

More fundamentally, it is unclear how a FRAND-related pricing obligation could be implemented. If the gatekeepers replaced or modified the advertising auction mechanism - for example, if prices were capped in some way - there is no guarantee that the advertiser with the highest willingness to pay (and hence who expects to make the most efficient use of a particular advertising slot) would win. This could result in a worse outcome for advertisers overall, even if total ad spending was reduced.

ENHANCING CONTESTABILITY IN SEARCH

The motivation behind the DMA's obligations for search engine providers appears quite different from the FRAND requirements discussed above. Here the aim is to enable contestability in an activity where the access provider has dominance (i.e. a horizontal concern), rather than ensuring fair treatment of third parties that

[3] The CMA found that Google's prices for search advertising were around 30% – 40% higher than those set by Bing. See https://www.gov.uk/government/news/new-regime-needed-to-take-on-tech-giants#:~:text=The%20CMA%20found%20that%20Google's,on%20newspapers%20and%20other%20publishers

rely on their platforms (a vertical concern). The EC is requiring gatekeepers to grant access to search data on FRAND terms because it is considered to be an essential input for competition - it refers to access to such data as an "*important barrier to entry and expansion, which undermines the contestability of online search engines*". The EC's thinking therefore seems to be that even if someone could come up with a better search algorithm than Google, they lack the data they would need to innovate and compete.

It is unclear whether the obligation to provide data access would be sufficient to allow newcomers to enter the market, although existing competitors may seek access to gatekeepers' data to improve their competitive position. Pricing of access may be an important determinant of how competition develops:

- Set the price too high and new entrants may think it is not worth taking the risk, even if they could get access to the data.
- Set the price too low and there is a risk of damaging the innovation that the regulation aims to foster. Google may no longer have an incentive to bring some of its own innovations to market if it knows it will have to share the relevant data with rivals. Similarly, if a successful rival was shaping up as a potential new Google, it might cease innovating in order to keep its customer base small and thus not be subject to gatekeeper provisions.

The challenge for the EC will therefore be to price access in a way that achieves three goals. First, the price should allow investors in new entrants the prospect of earning a reasonable margin on their own search/advertising services. Second, it should not be so low as to deter the very innovation that access pricing is intended to stimulate. And third, it should ensure that prices are not excessive, consistent with the approach of United Brands.

Determining the Goldilocks level of access pricing which could stimulate sustainable competition in the search market would appear to be extremely challenging given the complexity of the market and the underlying riskiness of entry. The EC has provided no guidance as to the approach that should be taken. Tools which have been used for similar market-opening access remedies in other sectors – in particular, cost-plus or economic replicability - do not seem to have a straightforward read-across to access to search data.

- All of the challenges associated with a price-cost test for app stores, outlined above, would apply equally to a **cost-plus** approach for search data. In particular, how do you identify and capture the relevant costs and what is the appropriate 'plus' that Google should be allowed on top of this?
- Alternatively, an **economic replicability** approach, whereby prices are set sufficiently low for small new competitors to profitably enter, could lead to significant market fragmentation. This would in turn erode the value of the data that Google generates, undermining its ability and incentives to continue to invest in its search and advertising services. Alternatively, the EC would need to decide, ex ante, how many competitors it thinks the market can efficiently support and then set a price that only firms with sufficient scale could afford. In this way Google would get some of the value for its data, but competition would be restricted to the top "X" alternatives. Such an approach, however, would depend on the EC being able to identify the magic number of firms, balancing competition with efficiency in the process.

THE DMA KICKS THAT CAN DOWN THE ROAD ON COMPLEX IMPLEMENTATION ISSUES

In contrast to other measures set out in the DMA, there is no bright-line test for compliance with the FRAND requirements. Furthermore, jurisprudence on what would constitute fair and/or reasonable pricing is limited and context-specific. The DMA leaves open many difficult questions about how FRAND should be applied to digital platforms, putting the onus on the gatekeepers to justify their terms. This is probably in part a deliberate attempt to future-proof the DMA and to allow the EC maximum flexibility in how it tackles any issues, both foreseen and unforeseen, that might arise. Indeed, it has been reported that MEPs had been pushing to extend FRAND requirements to all core platform services, but that their demand was scaled back to cover just search engines and social media (in addition to app stores) as a compromise.

The DMA also doesn't shed any light on how the EC sees the FRAND obligations interacting with the wider aims of the Act. One issue in this context is the potential tension between granting access on FRAND terms to core activities on the one hand while also trying to encourage entry and contestability in these activities. For example, if gatekeepers end up being forced to reduce access fees for app stores, this could undermine the DMA's efforts to encourage alternative stores by putting pressure on new entrants' margins.

For the set of services to which they already provide access (i.e. app stores, search engines and social networks), gatekeepers will likely seek to justify their existing terms and conditions or make small concessions. That would leave it up to the EC to take the step of enforcement, which may not be its immediate priority given the prevailing uncertainty and its limited resources. For search data, when coming up with a reference offer Google will need to weigh up the potential risk of enforcement against the risk of entry, in particular by copy-cat search engines looking to free-ride on its data.

The EC might prefer a light-touch approach to FRAND, at least initially, and instead focus its efforts on the other aspects of the DMA to see whether they produce better outcomes. However, gatekeepers will be obliged to comply with the DMA from day one, and it seems likely that third parties that feel they're being treated unfairly will start filing complaints as soon as the DMA comes into force. In short, the EC will need to begin grappling sooner rather than later with the host of complex challenges that FRAND raises.

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