THE EUROPEAN COMMISSION’S DRAFT REVISED MARKET DEFINITION NOTICE

A submission by Frontier Economics

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Frontier Economics is an economic consultancy that regularly advises clients on antitrust issues relating to European and national competition law.

We welcome the European Commission's endeavour to update the Market Definition Notice. We also agree that it is important to continue to recognise the value of market definition as a tool used to identify and define the boundaries of competition between undertakings. In this context, the purpose of this response is not to comment comprehensively on all aspects of the proposal, but rather to focus on a number of specific parts of the Notice that we believe can be further clarified or improved.

Product market definition

Risk of too strong a focus on product characteristics/functionalities

1 In our view, the revised Market Definition Notice risks placing too strong a focus on product characteristics/functionalities as a parameter for assessing demand substitution.[1]

2 In paragraph 51, the revised Market Definition Notice acknowledges the importance of identifying the parameters that are most relevant for choices of customers, as these are the ones that would allow the Commission to properly assess substitutability between products. However, the current draft provides no guidelines as to how the Commission would go about assessing such relevance, and instead consistently mentions product characteristics as the first parameter of interest.[2]

3 This could lead to too much weight being put on superficial similarities between products, based on a simplistic assessment of their functional characteristics, even when they are not the most relevant parameters for assessing customer choices.

4 This is a particularly material risk in the context of dynamic markets, where often product functionalities can be a poor guide to patterns of demand substitution. Products that fulfil the same underlying need for a consumer, but do so with products that look and function differently, can still be close competitors in terms of demand substitution.

5 For example, in many digital markets characterised by a high level of dynamism, the strongest competitive constraints often come from firms who have innovated and create a new (and better) way of serving consumers' needs. Their new product is an effective competitor precisely because it functions differently and better than the existing product in the market. Such differentiated products would therefore by

1 Similarly to the Commission's approach, the term 'product' in this paper is used as shorthand to also comprise services or technologies.

2 Paragraphs 28, 49-51 and 98

definition display different product characteristics/functionalities, but would nonetheless be particularly relevant to assessing demand substitution.

6 We note that, in paragraph 55, the revised Market Definition Notice does explicitly reference rapidly evolving industries and it acknowledges that '*the Commission may take into account the expected changes in substitution possibilities resulting from the change in competitive dynamics*'. However, the Commission provides no further guidance on when it considers that such expected changes will be taken into account, beyond indicating a few loosely defined necessary conditions.

7 When describing such necessary conditions, the revised Market Definition Notice refers back to the general principle according to which the Commission may take into account expected transitions in the structure of the market if some conditions are met.[3] However, this principle is not specific enough in describing such conditions. For example, it does not clarify what is meant by '*short-term or medium-term*', or '*sufficient probability*'.

High diversion ratios to products outside the candidate market should not be discounted

8 The revised Market Definition Notice states that *'high diversion ratios or (cross-price) elasticities to products outside the candidate market do not necessarily imply that the relevant market includes such products'*,[4] without providing any explanation of why this might be the case or examples of where this was found to be the case in the past.

9 On the contrary, high diversion ratios to products outside the candidate market are strong evidence that such products are exerting significant competitive pressure, and ignoring this would be entirely inconsistent with the Commission's stated intention of maintaining the hypothetical monopolist test as the guiding theoretical criterion to determine whether all sufficiently close substitutes have been identified.[5]

10 We invite the Commission to drop this statement or, at the very least, provide more clarity as to what conditions would need to be met for such high diversion ratios to be ignored.

A complete evidence set should be considered for supply substitution

11 The revised Market Definition Notice recognises that *'supply substitution can also be relevant for the definition of the relevant market in some cases, namely when it is as*

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3 Paragraph 16

4 Footnote 72

5 Paragraph 31

immediate and effective as demand substitution'.[6] However, when listing the types of evidence relevant for assessing supply substitution,[7] the Commission narrowly focuses on evidence of past substitution and barriers and costs with switching supply.

12 This misses out on evidence of hypothetical substitution and evidence on competitive constraints based on industry views. These have been rightly identified as relevant sources of evidence in relation to demand substitution section. However, they also constitute relevant sources of evidence to assess the potential for supply substitution and should therefore not be ignored.

Geographic market definition

The binary choice between EEA and global markets is too restrictive

13 When imports play a substantial role in the destination market, but competitive conditions in the origin location are sufficiently different, the revised Market Definition Notice indicates that geographic market definition should not be widened to include the import origin location, but that such imports are nevertheless taken into account in the calculation and assessment of market shares.[8]

14 In practice, this type of analysis is often applied in cases related to industrial products with a mature European sector and material imports from outside the EEA. However, such cases are also ones where an analysis of market capacities is important.[9] And the solution proposed in the guidelines of not widening the market but accounting for imports in the calculation and assessment of market shares only relates to sales market shares. Hence, this would unduly discount the competitive pressure posed by imports in circumstances where data on production capacities is used in the competitive assessment, and where the capacity used (or that could be used) to produce such imports is not accounted for in the analysis.

15 We argue that a solution to this issue is to not feel constrained by a binary choice of defining an EEA or Global geographic market. But rather, allowing for the possibility to define a market that includes the EEA plus those capacities outside the EEA that are credible competitors when it comes to serving the EEA. Doing so would allow the market to be expanded beyond the EEA, but without automatically widening it to a global market that includes all capacities, much of which might not realistically be useable to serve the EEA market.

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6 Paragraph 25

7 Section 3.2.2

8 Paragraphs 43-44 and 75

9 Paragraph 107

16 This solution would lead to a more sensible estimation of capacity market shares as well as an alignment between the capacity and sales market shares.

The level of financial distress of European producers should be considered as a relevant source of evidence

17 In section 3.3 of the revised Market Definition Notice, the Commission lists the categories of evidence that may be relevant for the assessment of the relevant geographic market. One category that is not included in the list is evidence on the level of financial distress of European producers, despite this potentially being a relevant indicator to assess the geographic market.

18 Again, in practice, this could often be relevant in cases related to industrial products with a mature European sector and material imports from growing markets outside the EEA. More specifically, there are sectors where European producers have very substantial fixed and sunk costs and (relatively) low variable costs and so have strong incentives to fill their capacities, even if it means accepting to sell their products at unsustainably low prices. This is because, in the short and medium term, it makes sense to maximise variable profits, even if these profits do not ultimately make it possible to recover the sunk costs. When the fixed assets are very long lived, this situation of unsustainably low pricing can persist for a long time.

19 This is important to the assessment of geographic market definition because it affects how the Commission should interpret evidence on import volumes. In these circumstances, the following can be true:

(a) the market is wider than EEA, and prices in the EEA are entirely dictated by the price of imports determined in global markets;

(b) EEA prices are below the level where EEA producers are financially viable; but

(c) EEA producers nonetheless still maximise profits by selling as much volume to EEA customers as possible (i.e. by matching or beating import prices); such that

(d) in practice, imports are used only to make up the difference between EEA production capacity and EEA total demand.

20 As a result, the observable level of imports is just the portion of local demand that cannot be met by local capacity. That might mean that in practice the share of imports is relatively low, even in markets where global prices are entirely determinative of price levels in the EEA. This is particularly likely to be the case when:

(a) EEA prices closely track global/import prices;

(b) EEA firms are not financially viable in the long term (i.e. earning returns below their cost of capital); and

(c) yet there is no evidence of material overcapacity in EEA producers that would otherwise explain these low levels of profitability.

21 In our view, even when import shares are modest, the Commission should still consider widening the market beyond the EEA in these circumstances.

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