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COMPETITION COMMITTEE**

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ROUNDTABLE ON TWO-SIDED MARKETS

-- Note by the Delegation of Chile --

This note is submitted by the Delegation of Chile to the Competition Committee FOR DISCUSSION at its forthcoming meeting to be held on 9 - 11 June 2009.

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TWO-SIDED MARKETS AND COMPETITION POLICY

-- Contribution from Chile --

1. Definition and some theoretical issues about two-sided markets

1.1. *What is a two-sided market and how can we determine this in practice?*

1. The initial stages of the theory of two-sided markets (2SMs) were closely related to the theories of network externalities and multi-product pricing. Products and services that bring together groups of users in networks are known as *platforms*, which provide infrastructure and/or rules that facilitate the groups' transactions and can take many different aspects. In some cases platforms can facilitate a transaction of products –as with cardholders and stores affiliated to a card-pay system, where the platform is physically the merchants' POS (point of sales or authorisation terminals)-, or of services, like shopping malls (stores on one side, potential customers on the other), newspapers (readers and advertisers), and supermarkets (providers and customers), among others.

2. As a result, 2SMs –also referred to as two-sided networks or broadly multi-sided markets-, are loosely defined as markets in which one or several platforms enable interactions between end-users. Since these interactions allow all user groups to benefit from trading, the platforms' owner(s) can define a proper charge scheme that might charge either or both sides.

3. The key issue of network externalities is that groups are linked together through the platform: neither of them would want to be there if it was not for the existence of the other side (cardholders value cards if they are accepted by stores; merchants value the access to more customers). In a 2SMs scheme, therefore, the platform's value to any given end-user depends on the number and size of users on the other side of the market. Because of network effects, then, successful platforms commonly enjoy increasing returns to scale, and so two-sided industries are sometimes dominated by a handful of large platforms. Even a single company could emerge getting hold of nearly the whole market, as does *Transbank* in the Chilean banking credit card-management industry.

4. Formally there is no single definition of 2SMs in the current literature¹. Rochet and Tirole (2003) put forward the following definition: "*A market is two-sided if the platform can affect the volume of transactions by charging one side of the market more and reducing the price on the other side by an equal amount; in other words, the price structure matters.*" Due to the network externalities, in 2SMs the price structure is relevant and affects economic allocations.

1.2. *Does it matter for antitrust analysis if a business has a 'two-sided markets' structure?*

5. It does indeed. 2SMs differ from other markets in a fundamental way: Platforms having different groups of end-users (on each side) incur in costs while furnishing both groups and can collect revenues from each, so the goal is to maximise their joint net benefit. Given that end-users are related to each other

¹ See, for instance, Rochet and Tirole (2003, 2005), Evans (2003), Caillaud and Jullien (2003), Wright (2004) and Armstrong (2005).

(by the network effect), and in order to define a profitable charge scheme, the platform owner must consider how an increase in the price charged to one group affects the others' willingness to be 'on board'. In this way the profit-maximising price for each side depends on (i) the price for the other side, (ii) the indirect network effects between the two sides and (iii) the costs on both sides. This explains why when facing platforms and 2SMs structure, usually one side of the market subsidises the other side, which might end up paying a price below marginal cost. As a consequence, the standard measures of competition for one-sided market –as, for instance, the Lerner Index for mark-ups, the consumer's surplus analysis and the corresponding deadweight loss, or even the relevant market definition using the SSNIP test- get biased. According to the recent developments in economic theory, they should not then be used to examine how a 2SMs really works, because it does not encompass the networks externalities. The latter's magnitude and relevance depend on the externality's size (or the cross-effects among groups) and hence on how "two-sided" the relevant businesses really are.

6. The economic literature also addresses this matter: As was pointed out by Evans (2003), because of demand interactions between the two sides of the market, "*market definition and market power analyses that focus on a single side will lead to analytical errors*".

7. One key element when dealing with a 2SMs is to evaluate if network effects (i.e., links between the two sides) (a) really show up, and (b) limit the extent to which a price increase on either side is profitable. A further issue when defining markets in the presence of 2SMs refers to the SSNIP test. First, when a price is increased demand will decrease as in standard markets, but there may be additional effects as well, arising from the other side that may or may not decrease the profitability of the price increase, according to the type of the network externalities involved. In addition, the cost of a product is typically not an efficient benchmark: Even the price set in a "competitive market" is not necessarily efficient, and high individual mark-ups may not necessarily indicate market power.

8. There is no magical formula to include the missed cross-effect, despite there is an analytical one for the Lerner Index which considers prices charged and price-elasticity for both groups, with the strong assumption that these share the same marginal cost (quite similar to the algebraic answer to a mark-up measure for a multi-product firm offering related products). Mostly, though, real world cases are more complex. Accordingly, the antitrust analysis should focus on platforms strategies' competitive effects rather than precise market definition or measures.

2. The Chilean competition system's experience with two-sided markets

9. Competition law in Chile underwent a major reform during 2004 when its Competition Act (DL 211) was subject to one of its most significant amendments. Its dual system considers, on the one hand, the competition agency (*Fiscalía Nacional Económica*, FNE), which is in charge of enforcing economic competition in domestic markets, being responsible for investigating any act which tends to restrict or hinder competition and, when necessary, submitting complaints to the decisional body. On the other hand, the Competition Tribunal (*Tribunal de Defensa de la Libre Competencia*, TDLC) is the decisional body, a highly specialised court, judiciary in nature, integrated by five expert judges –3 lawyers and 2 economists-, altogether autonomous from the government.

10. Since May 2004, 187 contentious causes have been submitted to the TDLC, not only by the FNE, but also by direct private complainants-, and 83 rulings have been issued. A quick overview shows that about 10 cases may have 2SMs implications, yet only one has been explicitly addressed to as such: *FNE v/s Transbank* (Ruling N° 29/2005), on credit-card management industry.

11. The TDLC has also issued 6 decisions in non-contentious procedures referred to merger and acquisition consultations², where at least 2 related industries with 2S platforms, namely, *Metropolis Intercom - VTR* (Decision N°1/2004), on the Paid TV services, and *BellSouth – Telefónica Móviles* (Decision N°2/2005), on the mobile phone industry. Although in these two rulings no explicit approach was adopted on 2SMs, the TDLC performed in both cases an exhaustive analysis of the direct and related markets affected by the operation.

3. Case review: Banking credit card-management: FNE v/s Transbank

3.1. Background – Key facts

12. *Transbank* is a firm owned by the banking institutions of Chile. It operates a network of more than 60 thousand affiliated merchants, an ever increasing number in response to a recent promotion of banking services affiliating merchants in regions, focusing on medium and low-medium income people.

13. Established in 1986 as a support vehicle of banks, *Transbank* started managing the *Visa* credit card and affiliating commerce willing to accept card payments. After several consolidating stages – including M&A operations with similar platforms and with its computer facilities' supplier- at present *Transbank* manages all banking credit cards issued in the country (*Visa, Mastercard, Magna, American Express* and *Diners Club*) as well as debit cards (same card used to accessing the banking ATM network), with national and international coverage (*Electrón* and *Maestro*), and also 'Webpay', the Internet payment service. Additionally, *Transbank* supplies the acquiring and operating services for cards issued by some large retailers.

3.2. Decision N° 1270/2003 and Ruling N° 29/2005

14. As a platform administrator for credit cards, during 2001 and 2002 *Transbank* was the sole supplier to the commercial stores accepting payment cards, and of computer facilities and operating terminals for its business. It was accused of abusing of this position by imposing a discriminatory pricing structure to card issuers and predatory and discriminatory prices to stores that accepted bank-issued cards.

15. The trial began before the former Antitrust Commission '*Comisión Preventiva Central*', and ended before the TDLC. The final ruling includes a partial settlement between FNE and *Transbank*, which provided for the reduction of operational fees on debit and credit cards and established a self-regulation scheme (*Plan de Autorregulación, PAR*) to be periodically overseen by the FNE. It also provided some measures on the access of commerce to terminals and related services. Finally, the TDLC imposed the firm a fine of approximately US\$60.000 for its discriminatory conduct consisting in returning an amount of money based on transactions made only to their shareholders and which did not benefit non shareholders issuers.

16. The PAR self-regulation scheme, approved by the TDLC, was the way to ensure that the different charges made to both the merchant side (*merchant discount*) and affiliated card issuers were not abusive.

² The Chilean Competition Act provides for voluntary merger consultation before the TDLC, through the public procedure established in its article 31. Those consultations are treated as non contentious causes by the TDLC. The law does not provide for mandatory pre-merger notification, except for certain firms and markets established by decisions of the TDLC and the former Antitrust Commissions (the predecessor of the TDLC). After a voluntary consultation has been filed, transaction through a contentious procedure cannot be challenged. Finally, under article 38 of the Freedom of Opinion and Speech Act (Law 19.733), enacted in 2001, media industry undertakings require a post-merger notification to the Competition Court (subsection 1). The same provision establishes that TV and Radio undertakings require previous approval from the Competition Court (subsection 2).

17. It was considered that, because this is a 2SM, its pricing structure should not necessarily be related to the costs of providing services to each side. That is why an objective pricing mechanism (as stated by the PAR), linked to economic criteria such as volume of transactions, a ticket average value and risk associated to each type of merchant, was applied onwards by the firm and disclosed in its institutional Web site to keep customers informed on this matter.