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ROUNDTABLE ON TWO-SIDED MARKETS

-- Note by the Delegation of the United States --

This note is submitted by the delegation of the United States 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

-- Note by the United States --

1. Introduction

advertisers have been used in economic analysis for decades.[2] In other markets, the interactions between the two sides of the market may be insignificant or may not be relevant for a particular antitrust issue. In *United States v. Microsoft Corp.*,[3] the U.S. Department of Justice (DOJ) alleged that Microsoft had taken actions to impede the distribution of Netscape Navigator. Although computer operating systems are a two-sided market with respect to PC users and application developers, the two-sidedness was not central for this part of the case.

2. Skewed Pricing Structures in Two-Sided Markets

5. A feature of many two-sided markets is a highly skewed pricing structure. That is, one group of customers pays a high price to use the platform, while the other group pays a very low or even negative price. For example, newspapers, web portals (e.g., Google or Yahoo.com), and websites offering information or entertainment content are often provided to readers for free, while advertisers pay the fees that cover the newspaper's or website's costs of production. In credit card systems, the transactional services (those services associated with the physical process of making a payment, as distinct from the supply of credit) are sometimes provided to cardholders for free. For credit cards that carry reward programs, the cost of the transactional services is subsidized by the rewards so that the effective price to a cardholder for using the card is negative. Merchants, on the other side of the market, however, often pay substantial fees for credit card transactions.

6. In a traditional market, prices either significantly above or significantly below production cost can raise antitrust concerns. In a two-sided market, however, a highly skewed pricing structure may be efficient. In order to maximize volume in the network, a platform may set prices above production cost on one side of the market in order to subsidize the other side. Perhaps the most basic reason for this is that the nature of externalities often differs across the two groups of customers.

banks. Thus, competition drives price on one side of the market up as it drives price on the other side of the market down.

12. In *United States v. Visa U.S.A., Inc.*, the DOJ had to consider this possibility when it challenged exclusionary rules that restricted the ability of American Express and Discover to compete for issuing banks.[7] Because American Express sets the highest prices to merchants of all of the credit card networks, it seemed possible that a ban on the exclusionary rules would drive Visa and MasterCard to raise their interchange fees to be closer to the merchant fees of American Express. This would, however, have occurred as part of an increase in competition. Since the banning of the exclusionary rules in 2004, Visa and MasterCard have introduced premium cards with higher interchange rates targeted at the same high-end consumers that American Express targets.[8] This may have happened for a variety of reasons, but it is consistent with a conclusion that increased competition with American Express led to an increase in interchange fees.

13. The nature of competition may also be very different on each side of a two-sided market. Competition may prevail on one side of the market, while the other side of the market may be subject to monopoly or oligopoly market power. For example, consumers in some areas of the United States may soon be able to choose among several different broadband Internet access services. This may lead to competitive pricing for the provision of access services to end-users. Such competition, however, may not be accompanied by competition for the providers of Internet content and applications who are on the other side of the market. A provider of Internet content or applications can address a *particular* consumer only if the provider obtains access to the broadband network to which the consumer has chosen to subscribe. This essentially gives the network operator a monopoly over access to its end-users.[9] The network operator may thus have the leverage to extract supra-competitive prices from providers of applications and content. This

4. Merger Analysis in Two-Sided Markets

14. In the United States, merger review uses the framework of the *Horizontal Merger Guidelines* (Guidelines)[11] issued jointly by the DOJ and the Federal Trade Commission (FTC). The methodology in the Guidelines aims to identify mergers that are likely to create or enhance market power or to facilitate its exercise.

4.1 Market Definition

15. The purpose of market definition is to identify a relevant market in which firms could effectively exercise market power if they were able to coordinate their actions. The market definition test in the Guidelines asks whether a hypothetical profit-maximizing monopolist, not subject to price regulation,

card market, this is a two-sided market. Merchants value a brand of debit more, the more cardholders carry the card; debit cardholders value a debit brand more, the more merchants accept it. PIN debit networks set similar sorts of fees to those of the credit card networks. The acquiring bank and issuing bank each pay a

23. In real estate markets, for example, there are

5.2.1 Barriers to Entry

27. Conditions of entry into a market often play an important role in establishing monopoly power under Section 2 of the Sherman Act. In two-sided markets, the network externalities operating across the two customer groups can make entry difficult. A platform must attract sufficient numbers of customers on both sides of the market in order to create value. In electronic payments for example, if a new platform were to focus on winning the business of merchants, without simultaneously tackling the job of getting cards into the hands of consumers, then merchants would not value the network because it would not deliver much incremental cardholder business. Thus a new platform must solve the problem of appealing to both sides of the market even when it is immature. This chicken-and-egg problem is essentially a coordination problem, and it can be a difficult one for a new entrant to solve.

28. Two-sided network externalities played an important role in *United States v. Microsoft Corp*.[21] Microsoft operates in a two-sided market for computer operating systems. An operating system connects two groups of consumers, PC users and applications developers. PC users value an operating system more