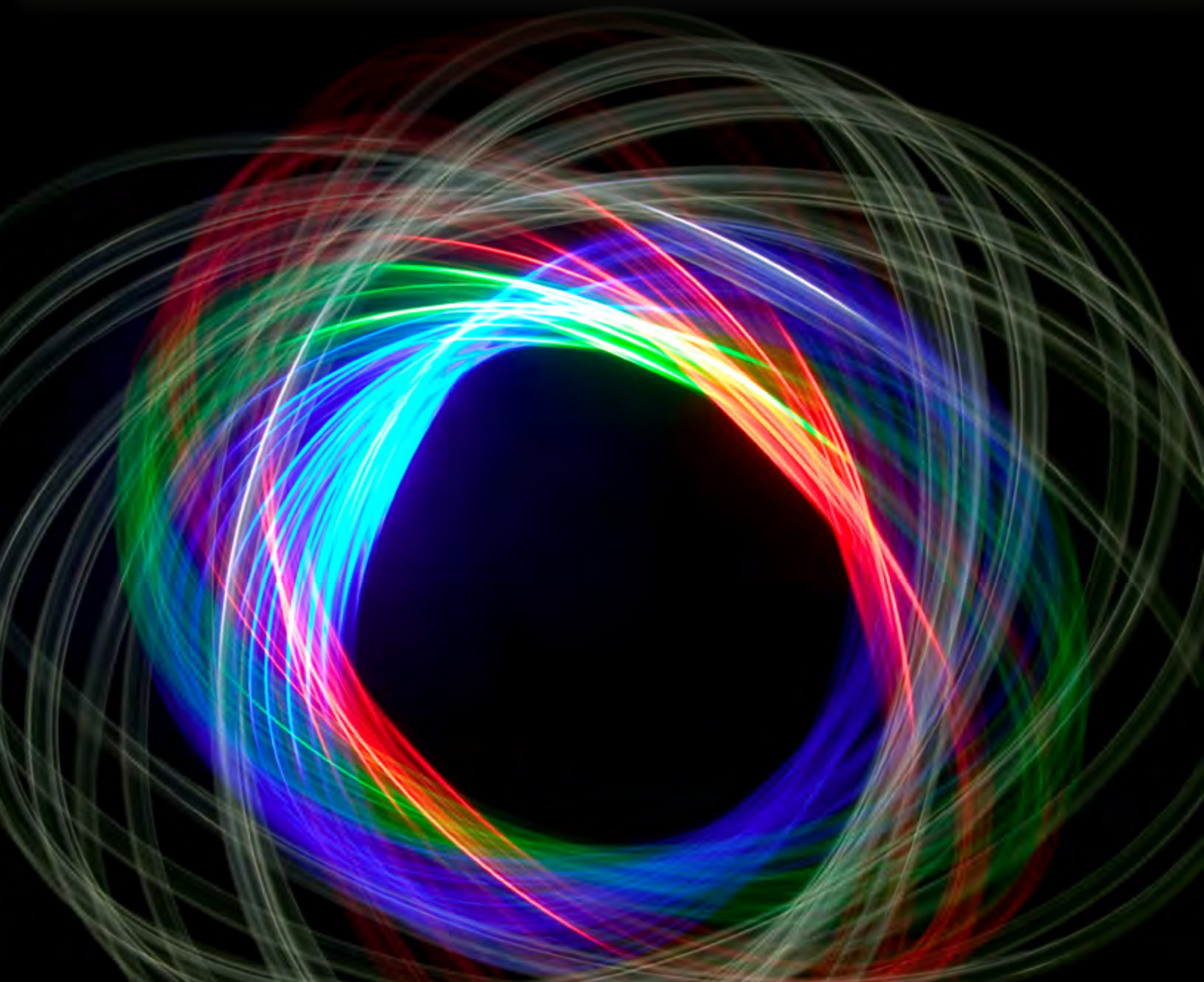


ECONOMIC ISSUES IN ASSESSING POTENTIAL AND NASCENT COMPETITION



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Potential and nascent competition have seen renewed interest from academics, antitrust practitioners, and United States enforcement agencies in recent years. For example, the Federal Trade Commission (“FTC”) focused on issues of potential competition during its Hearings on Competition and Consumer Protection in the 21st Century in 2018, as did the Organisation for Economic Co-operation and Development (“OECD”) during its 2020 Competition Meetings. The Antitrust Division of the U.S. Department of Justice (“DOJ”) and FTC’s recent request for information on merger enforcement included questions related to potential and nascent competition. Importantly, both potential competition and nascent competition describe competition that does not currently exist. The DOJ and the FTC’s concerns about potential or nascent competition arise because firms’ strategies (e.g., pricing or investment decisions) are informed by their expectations about competition in the future. During the last 25 years, the FTC consistently challenged transactions and agreements over concerns related to the elimination of future competition. Given the increased scrutiny on potential or nascent competition in antitrust matters, it is critical to understand the economic rationale that underpins the but-for world when evaluating such competition. In this article, the authors highlight some of these challenges, describe some illustrative examples, and discuss how these challenges may vary across different industries.

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I. INTRODUCTION

Potential and nascent competition have seen renewed interest from academics and antitrust practitioners in recent years.² For example, the Federal Trade Commission (“FTC”) focused on issues of potential competition during its Hearings on Competition and Consumer Protection in the 21st Century in 2018, as did the OECD during its 2020 Competition Meetings.³ The Antitrust Division of the U.S. Department of Justice (“DOJ”) and FTC’s recent request for information on merger enforcement included questions related to potential and nascent competition.⁴

Potential competition refers to a product or firm that could compete with existing products within a specific antitrust market in the future, but has not yet entered the market, and does not currently compete with existing products.⁵ While similar, potential competition is distinct from the related concept of nascent competition, which encompasses scenarios wherein an incumbent firm could be competitively constrained in the future by an existing market participant’s product or innovation.⁶ The difference between potential and nascent competition is that potential competition involves forecasting entry, including non-innovative entry such as entry of generic drugs, whereas nascent competition describes a firm that has already entered the market but is not yet a competitive constraint on existing products.

Importantly, both potential competition and nascent competition describe competition that does not currently exist. As we discuss in this paper, the economic issues that arise with concerns about potential and nascent competition are similar.

The DOJ and the FTC’s concerns about potential or nascent competition arise because firms’ strategies (e.g. pricing or investment decisions) are informed by their expectations about competition in the future.⁷ During the last 25 years, the FTC consistently challenged transactions and agreements over concerns related to the elimination of future competition.⁸ Of 82 such challenges over the last 25 years, pharmaceuticals and medical devices account for over 75 percent of cases.⁹

One catalyst for the ongoing debate was a paper entitled “Killer Acquisitions” by Cunningham et al.¹⁰ Focusing on the life sciences sector, the authors found that 5-7 percent of the acquisitions undertaken in the industry may have resulted in the termination of a target firm’s drug development project because of the acquiring firm’s interest in reducing competition for its own products. This finding sparked considerable interest in the antitrust community.¹¹ This debate has also been central in the tech sector, with commentators describing tech markets as having “kill-zones” where dominant tech incumbent firms are able to suppress competition through acquisitions of nascent competitors.¹²

Concerns about the elimination of potential or nascent competition have also been raised in other sectors, such as financial markets. In these cases, plaintiffs have alleged that financial institutions conspired to limit competition from emerging electronic trading platforms that, in

2 For example, Argentesi et al. (2019) and Lécuyer (2020) discuss merger control issues in the digital sector, where potential competitors are often acquired. See also, OECD, “Concept of Potential Competition,” *OECD Competition Committee Discussion Paper*, 2021; Argentesi, Elena, et al., “Merger Policy in Digital Markets: An *Ex-Post* Assessment,” *CESifo Working Paper*, 2019, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3507256; Lécuyer, Tristan, “Digital Conglomerates and Killer Acquisitions – A Discussion of the Competitive Effects of Start-up Acquisitions by Digital Platforms,” *Concurrences*, Vol. 1, 2020, pp. 42–50.

3 “FTC Hearing #3: Multi-Sided Platforms, Labor Markets, and Potential Competition,” *Federal Trade Commission’s Hearings on Competition and Consumer Protection in the 21st Century*, October 15-17, 2018; “The Concept of Potential Competition,” *Organisation for Economic Co-operation and Development*, June 10, 2021.

4 “Request for Information on Merger Enforcement,” *U.S. Department of Justice and U.S. Federal Trade Commission*, January 18, 2022.

5 Yun, John, “Potential Competition, Nascent Competitors, and Killer Acquisitions,” *The Global Antitrust Institute Report on the Digital Economy*, 2020, pp. 652–678 at p. 655.

6 Hemphill, Scott C & Tim Wu, “Nascent Competitors,” *University of Pennsylvania Law Review*, Vol. 168, No. 1879, 2020, pp. 1879–1910 at pp. 1886–9.

7 Note that in the litigation context, the alleged conduct that suppressed a potential or nascent competitor could have occurred in the past. In such instances the “future” is defined with respect to the timing of the alleged conduct.

8 Oldale, Alison, Bilal Sayyed, and Andrew Sweeting, “A Review of Cases Involving the Loss of Potential and Nascent Competition at the FTC, with Particular Reference to Vertical Mergers,” *Working Paper*.

9 Oldale, Alison, Bilal Sayyed & Andrew Sweeting, “A Review of Cases Involving the Loss of Potential and Nascent Competition at the FTC, with Particular Reference to Vertical Mergers,” *Working Paper*, p. 5.

10 Cunningham, Colleen, Florian Ederer, and Song Ma, “Killer Acquisitions,” *Journal of Political Economy*, Vol. 129, No. 3, 2021, pp. 649–702.

11 MergerFest 2019: Nascent (or Killer?) Acquisitions, *Cornerstone Research*, June 27, 2019; “Merger Control & ‘Killer Acquisitions,’” *EU Pharmaceutical Law Forum*, November 17, 2020

12 “American Tech Giants Are Making Life Tough for Startups,” *The Economist*, June 2, 2018.

the future, would have imposed competitive constraints on over-the-counter (“OTC”) trading regimes operated by defendant financial institutions by increasing pricing transparency and reducing search costs.¹³

Given the increased scrutiny on potential or nascent competition in antitrust matters, it is critical to understand the economic rationale that underpins the but-for world when evaluating such competition. Because it involves evaluating future competition, this evaluation is inherently uncertain and must assess several potential scenarios in the but-for world, including:

- a. What is the likelihood that the potential or nascent competitor survives and prospers, but for the alleged anti-competitive conduct by the incumbent? This is especially pertinent in markets or technologies with high failure rates, and where incumbent firms play a significant role in financing small firms through licensing and acquisitions.

- b. Would the nascent or potential competitor operate in the same relevant antitrust market (product or geographic) as the incumbent in the future? Such an evaluation becomes more complex if the nascent competitor is not in the same antitrust market as the acquirer at the time of the acquisition, or if the relevant antitrust market does not currently exist.

- c. What is the likelihood of entry and the but-for development timeline of the potential competitor and when (if ever) would it impose competitive constraints on incumbents?

In this article, we highlight some of the challenges relevant to the issues described above, describe some illustrative examples, and discuss how these challenges may vary across different industries.

II. WHAT IS THE CORRECT BUT-FOR WORLD?

Any anti-competitive effect of an incumbent’s conduct must be measured relative to an appropriately defined but-for world. However, the but-for world in these matters requires assumptions about how competition would evolve absent the alleged conduct. Notably, the but-for world requires assumptions related to the competitive strategy pursued by the potential or nascent competitor, the future product and geographic market the potential or nascent product competes in, and the potential competitor’s likelihood of entry and/or the potential or nascent competitor’s development timeline; all in the absence of the alleged anticompetitive conduct.

A. Evolution of the Competitive Landscape

The characterization of the but-for world in matters involving potential or nascent competitors is based on competition that may exist in the future. As a result, it is necessary to model the evolution of the potential or nascent competitor’s growth absent the alleged anti-competitive conduct. For example, in a case involving the acquisition of a nascent competitor, one would need to consider the competitive strategy pursued by the nascent competitor in the absence of the acquisition (i.e. the alleged anti-competitive conduct). The nascent competitor could pursue a number of strategies including:

- a. develop and grow independently so that its product imposes competitive constraints on the incumbent,

- b. develop and grow independently but specialize its product so that it does not impose meaningful competitive constraints on the incumbent,

- c. be acquired by a different firm in the same antitrust market as the incumbent,

- d. be acquired by a firm that does not compete in the same antitrust market,

- e. be driven out of the market due to the incumbent firm’s innovation.

¹³ See for example Class Action Complaint, *Litovich v. Bank of America Corp. et al.*, case number 1:20-cv-03154, in the U.S. District Court for the Southern District of New York.

The likelihood that the product of the nascent competitor will evolve to become a competitive constraint on the incumbent firm can depend on whether the nascent competitor is acquired; who acquires the nascent competitor; how the competitive landscape evolves. For example, consider a hypothetical nascent competitor in a market that contains several large incumbents, one of which has a product similar to that of the nascent competitor. If the nascent competitor is acquired by the incumbent with a similar product, that incumbent may shelve the nascent competitor's project or may integrate the acquired technology to the enhance the incumbent's existing product. In contrast, if the nascent competitor is acquired by a rival to this incumbent, it may be more likely that the rival develops the nascent competitor into a competitive constraint to the market.

Consider the *Facebook/Instagram* merger, which some commentators have cited as an example of a nascent acquisition where the regulators did not assess the competitive effects appropriately.¹⁴ In fact, the FTC brought a suit against Facebook challenging its past acquisitions of Instagram (and WhatsApp) alleging that these acquisitions were part of a campaign to snap up potential rivals to head off competitive threats.¹⁵ The Court initially dismissed the suit for lack of evidence, leading the FTC to refile its suit.¹⁶ In January of this year, U.S. District Judge James Boasberg allowed this suit to proceed, noting that the "agency may well face a tall task down the road in proving its allegations."¹⁷ Any assessment of pro-competitive or anti-competitive effects will depend on how one characterizes the but-for development of Instagram absent its acquisition. For example, but-for the transaction, would Instagram have evolved to be moderately successful versus evolving to be the service it is today?¹⁸

B. Market Definition

Characterizing a but-for world that incorporates future competition invariably requires an assessment of the product and geographic market definition to establish whether potential or nascent products will exert competitive pressure on the incumbent in the future. Establishing a future market definition for a potential or nascent product is inherently speculative, as such products may be expected to have differentiated characteristics from the incumbent's product in the future. This may imply that they compete in separate antitrust markets, or that the degree of overlap between the two products is limited. Such considerations have important implications for economic analyses.

As an example, consider recent antitrust actions in financial markets mentioned above. In these matters, it is not clear how comparable the product offered by these nascent exchanges or platforms would be to the OTC product offered by Defendants. For example, Plaintiffs allege that these exchanges would evolve to incorporate anonymous, all-to-all, trading with some form of pricing transparency.¹⁹ Trading in such an environment can be different than bilateral, OTC trading where counterparties are known and can develop relationships with one another, and the terms of trades may only be known by the transacting parties. The relevant economic analysis would need to include an evaluation of the extent to which market participants viewed the exchange product and the OTC product as sufficiently close substitutes to belong in the same relevant antitrust market or to impose meaningful competitive constraints on each other.

C. Likelihood and Timeline of Competitive Effects

An evaluation of whether potential or nascent products could become *future* competitive threats requires understanding how they would develop. In theory, this could involve considerations of how these products could evolve over lengthy time periods. However, actual evaluations of the

14 Yun, John, "Potential Competition, Nascent Competitors, and Killer Acquisitions," *The Global Antitrust Institute Report on the Digital Economy*, 2020, pp. 652–678 at p. 659.

15 Kendall, Brent, John D. McKinnon & Deepa Seetharaman, "FTC Antitrust Probe of Facebook Scrutinizes Its Acquisitions," *The Wall Street Journal*, August 1, 2019.

16 Memorandum Opinion, *Federal Trade Commission v. Facebook, Inc.*, United States District Court for the District of Columbia, Civil Action No. 20-3590 (JEB), June 28, 2021; Allyn, Bobby, "Judge Allows Federal Trade Commission's Latest Suit Against Facebook to Move Forward," *NPR*, January 11, 2022.

17 Memorandum Opinion, *Federal Trade Commission v. Facebook, Inc.*, United States District Court for the District of Columbia, Civil Action No. 20-3590 (JEB), January 11, 2022.

18 Commentators have argued that Instagram has been able to grow rapidly since the acquisition, from 30 million users before the acquisition to 1 billion users after the acquisition. Other commentators have argued that Instagram's success post-acquisition cannot be separated from Facebook's substantial investments into Instagram and Facebook providing tighter integration to Instagram. Yun, John, "Potential Competition, Nascent Competitors, and Killer Acquisitions," *The Global Antitrust Institute Report on the Digital Economy*, 2020, pp. 652–678 at p. 659; Zhuoxin Li, Ashish Agarwal (2016) Platform Integration and Demand Spillovers in Complementary Markets: Evidence from Facebook's Integration of Instagram. *Management Science* 63(10):3438-3458

19 Class Action Complaint, *Litovich v. Bank of America Corp. et al.*, case number 1:20-cv-03154, in the U.S. District Court for the Southern District of New York.

competitive impact of a potential or nascent competitor tend to be more focused on short-run development.²⁰ This narrowed focus may make it easier to draw reasoned inferences about the more immediate future.

Nonetheless, even in the short-run, there can remain uncertainty surrounding the fact and timing of entry of a potential or nascent competitor's products and whether or when they would become a future competitive constraint. Additionally, the point along the development timeline when a product is anticipated to impose a competitive constraint on incumbents may also be uncertain and can vary across industries. For example, in some industries a potential competitor may not impact the dynamics of a particular market until after the product is brought to market (e.g. life sciences). On the other hand, other industries may experience anticipatory competitive responses from incumbent firms even prior to the entry of a product in development (e.g. airlines).²¹

Consider the life sciences industry, where matters involving allegedly delayed generic entry involve modeling the uncertainty in timing of entry. Regardless of the source of the alleged delay, uncertainty exists with respect to when the generic manufacturer would have entered the market absent the conduct. For example, some cases of delayed generic entry require modeling the generic manufacturers' timeline for bioequivalence testing and manufacturing capabilities, among others. The duration of these various manufacturing and development processes has a direct impact on the but-for timing of generic entry.

In addition to uncertainty over the timing of entry, life sciences cases involving allegations of killer acquisitions can also involve uncertainty with respect to the fact of entry. Some of this uncertainty with respect to the fact of entry comes from the highly regulated development requirements in the pharmaceutical industry. New drugs in the U.S. must go through numerous phases of clinical testing to demonstrate that the drug is safe and effective before it can be approved for marketing.²² Only 12 percent of new drug candidates entering clinical trials ever receive marketing approval, and this process typically years in development.²³

Similar issues also arise in other industries. Consider the antitrust actions against financial institutions referenced above. In such cases, a relevant economic question is when (and if) nascent exchanges or platforms would gain sufficient volume that they would discipline prices across a relevant market. Such questions turn not just on whether the platform or exchange product is sufficiently substitutable with the OTC trading product (as discussed above), but also on the timeline at which the platform or exchange would attract new customers and whether there is a threshold volume at which they would exert market-wide price discipline.

Similar issues arise in merger contexts, where regulators have evaluated whether pipeline products can impose a competitive constraint in the future, absent the alleged conduct. For example, in Bayer-Monsanto, the settlement required "the divestiture of certain intellectual property and research capabilities, including 'pipeline' R&D projects."²⁴

III. UNCERTAINTIES RESOLVE DIFFERENTLY ACROSS CASES

The degree of complexity in evaluating potential or nascent competition can vary across industries. For example, many of the challenges discussed above about the unknown evolution of products may not be as relevant to delayed generic entry matters because of the regulatory and institutional framework of the life sciences sector. A main source of uncertainty from a future competition perspective in delayed generic entry cases is the timing of entry. In some sense, these are the least complex cases when it comes to assessing future competition.

Some of the tech matters and the killer acquisitions in life sciences matters discussed above can be more complex. Analyzing competitive effects in these settings requires an evaluation of the counterfactual evolution of a product, market definition, and timing, all of which inform future competition. This is similarly true of the examples of antitrust cases brought against financial institutions discussed above.

20 In fact, both the European Commission and the United Kingdom competition authorities note that a timeline of up to two years is normally considered when analyzing whether entry would be sufficiently swift to deter or eliminate the exercise of market power. "Guidelines on the Assessment of Horizontal Mergers Under the Council Regulation on the Control of Concentrations Between Undertakings," *Official Journal of the European Union*, ¶ 74; "Merger Assessment Guidelines," *Competition Commission and the Office of Fair Trading*, ¶ 5.8.11.

21 How Do Incumbents Respond to the Threat of Entry? Evidence from the Major Airlines," *The Quarterly Journal of Economics*, Vol. 123, No. 4, November 2008, pp. 1611–1633.

22 "Step 3: Clinical Research," *U.S. Food and Drug Administration*, January 4, 2018.

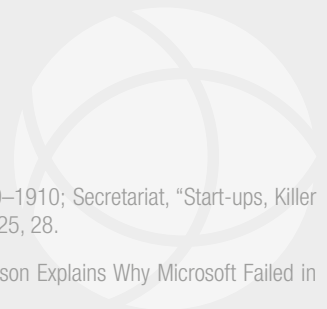
23 DiMasi, Joseph A., Henry G. Grabowski & Ronald W. Hansen, "Innovation in the Pharmaceutical Industry: New Estimates of R&D Costs," *Journal of Health Economics*, Vol. 47, 2016, pp. 20–33 at p. 23.

24 "Justice Department Secures Largest Negotiated Merger Divestiture Ever to Preserve Competition Threatened by Bayer's Acquisition of Monsanto," U.S. Department of Justice, May 29, 2018.

Regardless of the level of complexity, predicting the future is uncertain by its very nature. Several commentators advocate reliance on internal communications from the incumbent firm to inform choices about the firm's decisions about the future.²⁵ While such evidence is valuable, and demands serious consideration, such internal communications should be viewed in conjunction with other evidence in the matter, and not crowd the other evidence out. It is important to bear in mind that internal communications provide merely a firm's best estimates about the future (at times from one individual). Even setting aside the possibility of internal disagreement, firms — like antitrust agencies — do not always correctly predict the evolution of technologies or markets. Incumbents' forecasts about their own success can also turn out to be wrong: there are many examples in the business world of firms' (substantial) investments resulting in less successful products than they hoped. For example, Google's foray into social media with Google+ and Microsoft's efforts in smartphones did not in fact end up being successful.²⁶ As such, their forecasts about other firms, for which they have less information, may also be uncertain and inaccurate.

25 Hemphill, Scott C., & Tim Wu, "Nascent Competitors," *University of Pennsylvania Law Review*, Vol. 168, No. 1879, 2020, pp. 1879–1910; Secretariat, "Start-ups, Killer Acquisitions and Merger Control – Background Note," *Organisation for Economic Co-operation and Development*, May 12, 2020, pp. 24–25, 28.

26 Denning, Steve, "Five Reasons Why Google+ Died," *Forbes*, April 17, 2015; Haselton, Todd, "Departing Windows Chief Terry Myerson Explains Why Microsoft Failed in Smartphones," *CNBC*, March 29, 2018.



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