DISRUPTORS AND DISCONTENTED INCUMBENTS: AN ANTITRUST STORY RETOLD

BY ALEXANDER ELBITTAR, PATRICIO GONZÁLEZ, RUBÉN GUERRERO, ELISA V. MARISCAL & KIYOSHI TSURU[1]

1 This research was funded by PIRCE (Programa Interdisciplinario de Regulación y Competencia) at CIDE (Centro de Investigación y Docencia Económicas). PIRCE produces and issues papers and publications based on each author's own methods and analysis. Its output is independent of the policy positions of its current, previous, and prospective supporters, including those whose financial interests may be affected by the results or opinions expressed therein. A complete list of its financial supporters is available at www.pirce.cide.edu. Alexander Elbittar is Professor of Economics at CIDE and Advisor at Global Economics Group. Rubén Guerrero is Principal at Global Economics Group Latin America. Elisa Mariscal is Adjunct Professor of Economics and Law at CIDE, and Director at Global Economics Group. Patricio González and Kiyoshi Tsuru are Partners at TMI Law, and have undertaken work in the past for Roku. However, the views expressed in this paper belong to us alone, as do any mistakes. Corresponding author is Tsuru, ktsuru@tmilaw.com.mx.

CPI Talks…
…with Chairman Amir Ibrahim

The Nexus Between Innovation and Competition: Will the New Digital Technologies Change the Relationship?
By Elizabeth Webster

Platforms, Disruptive Innovation, and Competition on the Market
By Pierre Larouche

Speech, Innovation, and Competition
By Gregory Day

Disruptors and Discontented Incumbents: An Antitrust Story Retold
By Alexander Elbittar, Patricio González, Rubén Guerrero, Elisa V. Mariscal & Kiyoshi Tsuru

Ridesharing Platforms and the Long Tail of Mobility
By Rossi Abi-Rafeh & Emil Palikot

Visit www.competitionpolicyinternational.com for access to these articles and more!

I. INTRODUCTION: ROKU, DISRUPTION AND COMPETITION "FOR" THE MARKET

This short piece aims to shed light on current competition policy and regulatory discussion concerning the facts, the speed of government intervention, and its effects with regard to the entry of the Roku streaming service and its associated products in Mexico.

The development and adoption of new technologies and products are key to boosting economic growth. Economists have long quantified how such developments both enhance welfare and overall economic surplus for both consumers and innovators. Therefore, encouraging innovation, and, as a corollary, ensuring that conditions are ripe for the development of new products and services, while allowing innovators to recoup the necessary investments to take such initiatives, should be (and are) prominent among the goals of regulators. This is all the more so in the IT sector. Thus, it is not only necessary to remove *ex post* barriers to entry in a preemptive way that might impede such investments, it is also necessary to provide for timely intervention when the conduct of incumbents causes anticompetitive harm. Regulators must also allow competition to take place when there is no clarity as to whether there is any anticompetitive intent by an incumbent to begin with.

As all competition agencies note, their aim is to protect the process of competition itself and not to protect specific competitors. In markets where innovation and rapid changes take place to the benefit of consumers, regulators should therefore be vigilant to potential short- and long-term harms.

Bower and Christensen, for example, identify two different types of technological innovation.[2] The first type of innovation – so-called "incremental" innovation – improves the efficiency of existing technology, while continuing to meet the prevailing needs of users. In other words, it is limited to improving the characteristics of products that already exist, and that consumers already value. The second type of innovation – so-called "disruptive" innovation – offers new features not valued by mainstream customers of current technology but only by a niche. These new features perform worse along one or two dimensions but for this kind of consumers offer enough of the old features and other valuable characteristics that can be used in new markets or applications. This kind of innovation can be modified at accelerated rates. After some time, mainstream consumers may come to value these new features and decide to move or switch to the new technology.

In terms of competition policy, distinguishing between these categories (i.e. "incremental" and "disruptive" innovation) is important because, although both create benefits for society, incremental innovations are more likely to serve as a means to retain and entrench incumbent market power.

2 Bower, Joseph L. & Christensen, Clayton M., "Disruptive Technologies: Catching the Wave," Harvard Business Review, January 1, 1995. https://hbr.org/1995/01/disruptive-technologies-catching-the-wave.

www.competitionpolicyinternational.com
Competition Policy International, Inc. 2020© Copying, reprinting, or distributing this article is forbidden by anyone other than the publisher or author.

Disruptive innovation, by contrast, not only involves the introduction of new products or manufacturing processes — for example the internal combustion engine or digital photography — but also the emergence of new business models. In any case, the main characteristic of disruptive innovation is that it drastically alters markets as opposed to merely facilitating incremental technological development. It involves radical changes, unforeseen by the market, can dramatically alter the market shares of incumbent firms, and even create entirely new markets.[3]

II. REACTIONS TO INNOVATIVE ENTRY

Based on Streel and Larouche, we have identified four different types of responses to entry by a disruptor, each with differing effects on welfare:

(i) *No response*: the disruptor, typically a small firm, may be able to carry out the innovation and grow on its own;

(ii) *Acquisition to grow*: the large firm may acquire the disruptor and use its financial means to speed up the innovation deployment;

(iii) *Foreclosure*: the mainstream firm may engage in anti-competitive conduct to block the innovation (e.g. foreclosing the access to the low-end customer or by limiting the interface between the old value network and the new value network); and

(iv) *Acquisition to forestall*: the mainstream firm may acquire the disruptor to eliminate the innovation.[4]

The first two behaviors increase consumer welfare by allowing the emergence of a new product. Additionally, in the first case, it is possible for there to be an increase in competitive pressure towards established economic agents, which may reduce prices. Regarding behavior (iii) and (iv), it is clear that they have the effect of reducing welfare, since they impede the development of innovation.

In terms of competition policy, behaviors (ii) and (iv) must therefore be appropriately analyzed in merger review processes, since both have the potential to maintain an incumbent's dominance, even if there is the potential to bring a product or service to a wider audience or set of consumers. In the context of disruptive innovation, the analysis of the effects of a merger is, of course, more complex, and may depend on the life cycle of the innovation in question, its pace and projected rate of adoption, and its expected uses and outcomes in practice.

III. THE COUNTERFACTUAL: IS TOTAL WELFARE ENHANCED?

The entrance of innovators in multisided digital platforms — for example, Roku — is characterized by the existence of indirect network externalities. That is, the greater the number of content generators, the greater the potential consumer audience for content. Vice versa, the greater the number of potential consumers, the greater the number of potential content generators.

Therefore, the analysis of welfare in these markets — and any potential harm due to the absence of effective competition — must take into account both sides, i.e. both (i) content generators, and (ii) consumers (or the "audience"). To reach a point of ignition, a digital platform requires a critical mass of customers and content generators on both sides, which allows it to realize these network externalities. Furthermore, in the presence of a platform incumbent with market power, the entry of a new competitor is usually inhibited by switching costs that would be incurred by both audiences and content generators alike.

Finally, the entry of new innovative companies reveals a dynamic aspect of competition. Specifically, innovative entry can result in market expansion, and enhanced product diversity for consumers. It is through the creation of a wide variety of better products derived from innovation that new markets are created, satisfying new consumer needs. This is the way in which dynamic competition translates into competition "for" the market. This is why barriers to entry that impede innovation not only stop society from attaining the so-called "production possibility frontier" (i.e. the curve that shows the maximum possible output combinations of two goods or services an economy can achieve when all resources are fully and efficiently employed), but also limit the potential expansion of the economy overall.[5]

---

3 See OECD. 2015. "Hearing on Disruptive Innovation," Directorate for Financial and Enterprise Affairs Competition Committee. http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=DAF/COMP(2015)3&docLanguage=En.

4 Streel, A. & Larouche, P., "Disruptive Innovation and Competition Policy Enforcement," OECD Working Paper DAF/COMP/GF(2015)7, available at https://papers.ssrn.com/abstract=2678890.

5 Motta, Massimo, Competition Policy: Theory and Practice. Cambridge University Press (2004).

www.competitionpolicyinternational.com
Competition Policy International, Inc. 2020© Copying, reprinting, or distributing this article is forbidden by anyone other than the publisher or author.

IV. HARM TO COMPETITION: THE CASE OF ROKU IN MEXICO

Roku was spun out of Netflix in 2008 as a standalone company, to become a streaming platform that could connect "the entire TV ecosystem." Among the innovations it introduced were: the first app store for TV-based platforms; the first universal search utility for streaming TV services, the ability for users to search for content across multiple apps and to find the best price based on subscriptions and other options; the first streaming stick (i.e. a device not bigger than a thumb drive that plugged directly into a TV port and allowed streaming of television shows, movies, music, games and other content from the Internet), the first dedicated TV streaming operating system; and the lowest cost streaming player.[6]

But one key disruption brought about by Roku was the inclusion of a platform within its business model. The income from this platform is derived from revenue sharing arrangements between Roku and content providers, as well as income from advertising.

Roku's size as measured by the number of active accounts — those that stream content on Roku in the past 30 days — is equivalent to the third largest US pay TV company (over 30 million "households"). This is obviously a serious competitive challenge for existing pay TV companies, even though Roku has licensed its operating system, software, hardware, and platform to operators as a means to retain and expand existing pay TV customer bases. This strategy has been successful in appeasing incumbents in the UK, Germany, Italy, the Philippines, and Australia. However, in Mexico the outcome was different.

Roku launched in Mexico in 2015, and experienced rapid market adoption. It secured rights to over 4,000 content channel offerings, and its hardware was granted shelf space in every major retailer in Mexico. In 2017, however, its hardware sales were blocked by a court order arising from a complaint from the incumbent pay TV provider, which asserted allegations of copyright infringement, claiming that Roku was responsible for the actions of third parties that utilized its platform to engage in video piracy.

It took 16 months for Roku to get a Federal appellate court order to lift the first instance court injunction which prohibited the sale of its hardware in major physical and online outlets in Mexico. Hence, Mexico became the exception among the 23 countries in which Roku operated. Only in Mexico had a court blocked the sale of Roku hardware products for more than a year. The overall background and circumstances of this case did not pass unnoticed in the press or public opinion. Several prominent personalities declared their dissatisfaction.[7]

V. ON THE MERITS OF THE CASE

A core argument in Cablevision's (i.e. the incumbent's) complaint was that Roku was enabling piracy. It is not clear that this complaint was meritorious: Roku uses anti-piracy tools to reduce the potential for violation of copyright. This was not the first time that the incumbent tried to prevent the entry of a disruptor that threatened its position in the pay TV market. The Federal Telecommunications Institute ("IFT") had previously investigated the incumbent's refusal to license its channels to an online video-on-demand provider on the grounds that it was not obliged to license its channels to companies that did not have a concession to provide Pay TV services.[8]

The main allegation presented on behalf of Roku by the affected retailers was that the incumbent was engaging in the use and abuse of IP regulation and the legal system in general to bar a competitor from introducing a new product. This was a space in which the incumbent ISP (Cablevision itself) did in fact compete (i.e. Cablevision is a vertically integrated business encompassing the production and distribution of content, and was in fact developing its own digital streaming business). Cablevision used its dominant position in the restricted pay TV and local cable businesses to pursue sham litigation to foreclose the growth of a new disruptive player. It underscored the lack of preparedness of the Mexican legal system to detect and halt this type of foreclosure and to rapidly label it a competition matter.

Preventing anticompetitive harm in this nascent industry would have required faster action, as three recent reports on digital markets emphasize. Unfortunately, the situation was allowed to linger for 16 months.

---

6 See https://ir.roku.com/node/6671/html.

7 See https://busquedas.gruporeforma.com/reforma/Libre/VisorNota.aspx?id=6805330%7ClnfodexTextos&md5=ace7bdb6a9fc716d3edfeac64560b087&fbclid=I-wAR3yOc_7MuOj8bw5737__OPoeQibAj_TWfnyhagG5rhNlSaVCR80UWsMK78, and https://luisgyg.com/a-quien-beneficia-no-roku-en-mexico/.

8 Case E-IFT/UC/DGIPM/PMR/0005/2013 available on: http://www.ift.org.mx/sites/default/files/conocenos/pleno/sesiones/acuerdoliga/versionpublicapift230915417.pdf.

www.competitionpolicyinternational.com
Competition Policy International, Inc. 2020© Copying, reprinting, or distributing this article is forbidden by anyone other than the publisher or author.

The other problem Roku faced was the unwillingness of antitrust authorities to address the category of cases which lie at the intersection of antitrust rules and sham litigation or the opportunistic use of regulatory rules. The key question that emerges from Roku's experience is how to articulate workable legal tests to identify whether an agency faces an antitrust problem or not. This was always an inherently difficult question, but in this case the problem was compounded by the fact that, since 2014, there are two potentially competent regulators. Specifically, depending on the facts of a given case, either the Federal Economic Competition Commission ("COFECE") or the IFT could potentially have jurisdiction.

VI. INTERNATIONAL EXPERIENCE

The European and U.S. legal systems have developed doctrine and case law concerning sham or vexatious litigation. Moreover, competition authorities and courts in the U.S. and Europe have developed relevant legal standards and recognized theories of harm based on effects, and have set out categories of empirical evidence that can be used to support claims of anticompetitive behavior and abuse of legal proceedings.

In contrast to the European and U.S. legal systems, Mexico does not have a developed doctrine concerning sham or vexatious litigation, either in legislation, or in the practices of its antitrust agencies and courts. The only rules resembling principles concerning sham or vexatious litigation in the Mexican legal system are civil procedural rules that forbid the submission of meritless or groundless actions, and the generic civil law rules governing damages for the abuse of legal rights. These rules, along with the general prohibition set forth under Article 56-XI of the Federal Economic Competition Law ("LFCE"), which forbids increasing costs, altering production processes, or reducing the demand of an economic agent, allow Mexican authorities to determine the existence of and punish sham or vexatious litigation.

On the other hand, the Mexican federal courts have been developing jurisprudence that would preempt and fine the instigation of frivolous or abusive litigation. The jurisprudence is associated with temerity and bad faith litigation as concepts needed in order to allocate legal costs,[9] procedural probity,[10] and clearly malicious or improper submissions and resources.[11] Mexico still has a long way to catch up to international experience.

The abuse of administrative and judicial proceedings is not unknown in Mexican legal practice. Even in the absence of a specific sham litigation doctrine, there are certain rules, principles and case law that aim to prevent or restrain the use of public bodies for illegitimate purposes, such as delaying the resolution of a proceeding, or causing damage or inconvenience to counterparties through the abuse of a legal right. In this context, it seems that Mexican agencies and courts have not yet seized the opportunity to employ the notion of anticompetitive conduct consisting of hindering the competitive process established under Article 56-XI of the LFCE, to find the existence of conduct consisting of sham litigation to inhibit the entry of disruptors. To do so, it would be necessary to move away from traditional form-based competition rules, and to employ an effects-based analysis.

An effects analysis would focus on consumer harm caused by economic agents. Specifically, any such investigation would need to be carried out, on a case by case basis, using reasonable and consistent economic analysis, backed up by a study of the relevant incentives, solid data and evidence, and a robust understanding of the dynamics of the market. Such a doctrine could be introduced, based on a systematic, comprehensive interpretation of the relevant Mexican rules, backed up with a solid theoretical backbone, and good will on behalf of the authorities.

9. Thesis ID number 240981. https://sjf.scjn.gob.mx/SJFSist/Paginas/DetalleGeneralV2.aspx?Epoca=1e3e10000000000&Apendice=1000000000000&Expresion=240981&Dominio=Rubro,Texto&TA_TJ=2&Orden=1&Clase=DetalleTesisBL&NumTE=0&Epp=20&Desde=-100&Hasta=-100&Index=0&InstanciasSeleccionadas=6,1,2,50,7&ID=240981&Hit=1&IDs=240981&tipoTesis=&Semanario=0&tabla=&Referencia=&Tema=.

10 Thesis ID number 2018319. https://sjf.scjn.gob.mx/SJFSist/Paginas/DetalleGeneralV2.aspx?Epoca=1e3e10000000000&Apendice=1000000000000&Expresion=2018319&Dominio=Rubro,Texto&TA_TJ=2&Orden=1&Clase=DetalleTesisBL&NumTE=1&Epp=20&Desde=-100&Hasta=-100&Index=0&InstanciasSeleccionadas=6,1,2,50,7&ID=2018319&Hit=1&IDs=2018319&tipoTesis=&Semanario=0&tabla=&Referencia=&Tema=.

11 Thesis ID number 188538. https://sjf.scjn.gob.mx/SJFSist/Paginas/DetalleGeneralV2.aspx?Epoca=1e3e10000000000&Apendice=1000000000000&Expresion=188538&Dominio=Rubro,Texto&TA_TJ=2&Orden=1&Clase=DetalleTesisBL&NumTE=1&Epp=20&Desde=-100&Hasta=-100&Index=0&InstanciasSeleccionadas=6,1,2,50,7&ID=188538&Hit=1&IDs=188538&tipoTesis=&Semanario=0&tabla=&Referencia=&Tema=.

www.competitionpolicyinternational.com
Competition Policy International, Inc. 2020© Copying, reprinting, or distributing
this article is forbidden by anyone other than the publisher or author.

VII. CONCLUSIONS AND RECOMMENDATIONS

Disruption is not a new phenomenon, and competition both "in" and "for" various markets has occurred over time. So too have foreclosure strategies against disruptors by various incumbents. But what has changed substantially in recent times is the speed at which these changes occur. Because competition "for" the market involves incipient (or not yet fully formed) markets, a considered analysis requires a long view. The correct analysis would look not only at the immediate effects of given conduct, but would also consider dynamic efficiencies, long run costs and benefits, and long-term consumer welfare. In other words, the analysis would not be limited to immediate price decreases and benefits to consumers, but would also take into account the long-term consequences of not having an innovative or disruptive product or service at an earlier time — or alternatively, of hindering the growth of an efficient and dynamic competitor by overprotecting competitors. In short, the analysis would look to whether consumer surplus has been forgone.

Given that it is difficult to identify whether a specific innovation is disruptive or not, competition agencies should carefully assess conduct relating to companies that provide innovative services using a novel business model. This does not necessarily imply the creation of new analytical tools. Rather, it implies a different use of the existing tools in a manner that would protect and foster the development of new markets. For dynamic and innovative markets, the essential role of competition policy should be to police markets in such a way that dynamic efficiencies and economic growth can be realized. Authorities should take a long-term view. The objective — front and center — when deciding to intervene or not in a given case, should be to ensure that new players can participate, under equal conditions, in actual or potential markets.

www.competitionpolicyinternational.com
Competition Policy International, Inc. 2020© Copying, reprinting, or distributing
this article is forbidden by anyone other than the publisher or author.

CPI COMPETITION POLICY INTERNATIONAL

CPI Subscriptions

CPI reaches more than 35,000 readers in over 150 countries every day. Our online library houses over 23,000 papers, articles and interviews.

Visit competitionpolicyinternational.com today to see our available plans and join CPI's global community of antitrust experts.