

The Chinese Supreme Court issues the first decision based on economic analysis under Anti-Monopoly Law (Qihoo v. Tencent)

China, Unilateral practices, Abuse of dominance, Market sharing, Market definition, Effect on competition, Information technology

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On October 16, 2014, the Chinese Supreme People's Court (SPC) announced its ruling on the landmark antitrust litigation brought by Qihoo 360 against Tencent. The decision marked the SPC's first ruling on a matter filed under China's Anti-Monopoly Law (AML), which came into effect in August 2008. The SPC affirmed the decision of the Guangdong Province People's High Court (High Court) that Tencent did not have market dominance in the provision of instant messaging (IM) services in China and the complained of conduct had not violated the AML. However, the SPC differed sharply with some of the approaches the High Court took, particularly with respect to the definition of the relevant markets.

The High Court found Tencent not dominant because of its low market share, which was derived from a relevant product and geographic market definition resulting from the misuse of the "small but significant and non-transitory increase in price" (SSNIP) test. Although arriving at the same conclusion of no dominance, the SPC rejected the High Court's definition of the relevant markets, and went to great lengths to describe the analytical framework it adopted to define the relevant product and geographic markets.

In addition to its criticism of the High Court's flawed market definition, the SPC de-emphasized the role of market definition and market share in assessing a firm's dominance. Indeed, the opinion clearly articulated the need to go beyond market share in abuse of dominance cases, and laid out the additional factors it considered in concluding that Tencent did not have a dominant position in IM, despite persistently high market shares. Specifically, the SPC stressed the importance of evaluating direct evidence of competitive effects, which is in line with the movement towards an effect-based approach adopted by the enforcement agencies and courts in the US (and to a lesser extent in Europe).

In this article, I first provide some background on the dispute between Qihoo 360 and Tencent. I then discuss two key points in the opinion : (i) the SPC's criticism of the High Court's definition of

the relevant market and its de-emphasis of market shares in the assessment of dominance ; and (ii) the effect-based analysis of market dominance conducted by the SPC which focuses on entry, direct evidence of competitive effects, and internet platform competition. Although I do not necessarily agree with the conclusions of the SPC's effect-based analysis in this case, the decision is noteworthy as it signals the SPC's desire to move away from a formalistic analytical approach based on market definition towards an approach based on competitive effects analysis. In my view, this movement only strengthens the role of economics in antitrust cases in China, and the SPC opinion underlines the importance of undertaking a solid economic analysis of the facts specific to the case, rather than simply relying on formalistic market definitions in abuse of dominance cases.

Background

Qihoo 360 and Tencent are two large integrated providers of internet products and services in China. Qihoo 360 builds its user base via its antivirus products, while Tencent builds its user base around its core product, the QQ IM software. Each company offers its core product for free and profits from selling online advertising and offering value-added services to users. Conflicts between Qihoo 360 and Tencent had been escalating over the years and reached a peak on October 29, 2010 when Qihoo 360 introduced its 360 Bodyguard software that allowed users to control the number of ads the QQ software could display. On November 3, 2010, Tencent responded by making its QQ IM software incompatible with all Qihoo software, and informed all QQ users that to continue to use any QQ software, they would have to uninstall all Qihoo software from their computers (the "choose one from two" event). Within 48 hours, Qihoo 360 lost around 10% of its users. There was substantial public outcry, and on November 4, 2010, the Ministry of Industry and Information Technology (MIIT) intervened. Qihoo 360 agreed to discontinue its 360 Bodyguard software, while Tencent agreed to reinstate compatibility with Qihoo 360's software again.

Qihoo 360 filed a complaint with the High Court on November 15, 2011, alleging that Tencent had a dominant position in the provision of IM services in mainland China, and that Tencent had abused its market dominance by engaging in the "choose one from two" event to eliminate and hinder competition in violation of the AML. The High Court ruled in favor of Tencent, Qihoo 360 appealed, and the case was heard in front of the SPC in November 2013. The central points of the dispute were as follows :

i. *Relevant product market definition* : The High Court ruled that since IM users were very price sensitive, if the price of IM increased from free to positive, users would switch to another free service. As social networking service (SNS) websites and microblogs also offered IM services, the relevant product market should include at least IM, SNS, and microblogs. Further, internet platforms should also be considered as a relevant product market. Qihoo 360 argued the misuse of the SSNIP test by the High Court led it to wrongly include SNS and microblogs in the same relevant product market as IM.

ii. *Relevant geographic market definition* : The High Court concluded that internet providers and users were without national boundary, and thus the relevant geographic market was worldwide. Qihoo 360 argued the High Court did not consider the barriers foreign IM providers faced in China, nor did it take into account the continual declining share of foreign IM providers since 2006. Qihoo argued the relevant geographic market was limited to mainland China.

iii. *Market dominance and abuse of dominance* : The High Court concluded that Tencent was not dominant, as users could choose from many alternative IM services, and barriers to entry were low. Further, Tencent did not violate the AML because it did not have a dominant position in the IM market to abuse. Qihoo 360 argued Tencent's IM share was persistently high and growing ; moreover, the "choose one between two" event was indicative of Tencent's dominance.

Relevant market definition and the role of market share in assessing market dominance

The SPC notes the basic purpose of the hypothetical monopolist test (HMT), a widely used analytical test in defining a relevant market, is to determine the degree of substitutability between the focal product and alternative products based on relative changes in certain variables regarding these products. Although the SSNIP test is a commonly used variant of the HMT, the SPC points out the SSNIP test may not be appropriate in defining a relevant market in many circumstances as, for example, when competition among firms focuses more on quality, service, innovation, and users' experience rather than on price. In particular, as in this case, when the price of the product at issue (QQ IM service) is offered free of charge, a price increase from zero to any amount (however small it is) would (in percentage terms) be "equivalent to an infinite change in price, implying a major change in the product characteristics or the business model."

The SPC is highly critical of the High Court's misuse of the SSNIP test to define a relevant product market that wrongly includes products that are not close substitutes in the same market. Instead, the SPC indicates that using a variant of the HMT based on a "small but significant and non-transitory decrease in quality" (SSNDQ) would have been a more appropriate methodology in defining the relevant product market when the product at issue is offered free of charge.

The SPC emphasizes that relevant market definition should focus on demand-side substitution factors such as product characteristics, functionality, quality, and access, evaluated from the point of view of the consumers located in mainland China. "When necessary," the analysis may be supplemented by consideration of supply-side substitution [1]. The SPC disagrees with the High Court's product market definition which includes "at least IM, social networking services (SNS) and microblogs." The SPC notes SNS and microblogs are "clearly different" from IM in terms of many important product characteristics [2], and cites third party industry reports indicating that SNS and microblogs, and IM products serve different consumer needs [3]. The SPC criticizes the High Court for ignoring these demand-side differences between SNS and microblogs, and IM services. The SPC is particularly critical of the High Court for wrongly applying the SSNIP test in defining the relevant product market, which led to its overstating of the substitutability between SNS and microblogs, and IM.

Regarding relevant geographic market definition, the SPC recognizes that legal and regulatory restrictions imposed on foreign-based providers present real entry barriers in some sectors in China, including the provision of IM services. The High Court ruled that the relevant geographic market was worldwide, since foreign-based IM service providers were offering services to users located in mainland China, and Tencent's IM service was available to users located outside of China. The SPC concludes that this approach to relevant geographic definition was incorrect. Whether China-based firms provide IM services to users outside of China, and whether users located outside of China use services provided by China-based firms, is not relevant. The focus of relevant geographic market definition should be whether foreign-based suppliers can enter China in a timely manner and act as

effective competitive constraints in response to a SSNDQ of the IM services available to users in China.

Citing the analysis of Qihoo 360's economic expert, the SPC first notes the IM services used by the vast majority of Chinese users are provided by mainland China-based firms. It then explains, in considerable detail, the numerous legal and regulatory obstacles foreign-based firms have to overcome in order to begin offering IM services to users in China [4]. The SPC concludes that it is unlikely foreign-based providers could enter China in a timely manner and act as effective competitive constraints on the incumbents. Thus, even in the absence of cross border transportation costs in providing IM services in China, the relevant geographic market is mainland China only.

Having defined the relevant market as the provision of IM services in mainland China, the SPC notes that in general, the higher a firm's market share, and the longer it is able to maintain its high share, the more indicative it is of the firm's market dominance. However, the SPC cautions that "market share is only a rough and potentially misleading way to determine a firm's market dominance." Despite Tencent's persistently high market share in the relevant market (more than 85% in terms of active usage) over a relatively long time period, the SPC rules it cannot reach a conclusion regarding Tencent's dominance based on market share. Specifically, the SPC explains, since competition in the provision of IM services is highly dynamic, the boundary of the relevant market is not as clear as that of more "traditional" markets. Hence, it argues, one cannot "rely too much" on the implication of market share in assessing market dominance, but should instead focus more on factors such as market entry, the competitive constraints resulting from internet platform competition, and direct evidence of the effects of Tencent's conduct on competition.

The SPC's effect-based approach to assessing market dominance

Evidence of entry and expansion plays a pivotal role in the SPC's conclusion that Tencent does not have market dominance in the provision of IM services in China. However, the relative scale of the entrants does not appear to be particularly relevant in the SPC's decision. The SPC also notes that it is not always necessary to clearly define the boundary of the relevant market in abuse of dominance cases, and when the boundary of the relevant market is unclear, as in this case, one can rely on direct evidence of the competitive effects of a firm's conduct in assessing market dominance. Further, the SPC acknowledges the role that internet platform competition plays in abuse of dominance cases.

Entry and expansion

The SPC concludes that entry and expansion is relatively easy in the provision of IM services in China. It takes note of the relatively large number of alternative IM services available to users at the time of the dispute, and the firms that have entered into the provision of IM services in China in recent years. Citing the rapid growth of some of these IM providers, measured in terms of the number of unique monthly active users (monthly coverage), the SPC concludes that Tencent does not have the ability to control output or other trading terms, since users can readily switch to these alternative IM services [5].

The SPC focuses on the growth in monthly coverage of a few IM service providers in recent years. However, monthly coverage does not capture the intensity of usage of an IM service ; so it is

questionable whether the growth in monthly coverage is an appropriate proxy for the ability and effectiveness of the smaller IM service providers and new entrants to act as competitive constraints on Tencent. In fact, the SPC opinion notes IM providers compete for users' attention. It is unclear why the SPC does not consider active usage, which is a more relevant measure of users' attention or preferences (and hence the competitive significance of an IM service) in determining if Tencent has market dominance.

While the SPC recognizes active usage is an appropriate measure of market share in this case, it overlooks or downplays the following key facts presented at trial by Qihoo 360's economic expert : Tencent's share (measured in terms of active usage) has been increasing since 2007 ; Tencent's share of active IM usage was over 20 times larger than that of the second largest IM provider at the time of the dispute ; and despite all the entry and expansion of IM services in recent years, Tencent has been able to maintain close to 90% market share over time, while not one of its competitors has been able to win any meaningful share from Tencent. Tencent's ability to sustain such a high and rising share in a market, even if it was "dynamic", should itself be a testament of its market strength.

Direct evidence of competitive effects

In line with the approach increasingly undertaken by US and European enforcement agencies and courts, the SPC acknowledges that although defining a relevant market can be an important analytical step in evaluating a firm's market position and in analyzing the effect of a firm's conduct on competition, it is not a goal in itself in abuse of dominance cases. Because of the limitation and availability of evidence, it can be difficult to clearly delineate the market boundary. However, direct evidence can be utilized to evaluate a defendant's market position and the competitive effect of the complained of conduct. Hence, it is not always necessary to clearly define the boundary of a relevant market in abuse of dominance cases.

The "direct evidence" the SPC focuses on is the change in the monthly coverage of Tencent's major competitors from October 2010, the month prior to the "choose one from two" event, to November 2010. It finds the monthly coverage (i.e., the number of unique monthly active users) of MSN, Fetion, and Aliwangwang increased by 61.9%, 10.0%, and 5.1%, respectively, and that these increases are all higher than the average monthly increase during the previous three months. The SPC determines that these increases in monthly coverage of Tencent's competitors during the month of the "choose one from two" event, along with the observation of a few IM providers engaging in promotional activities around the same time of the event, is "convincing evidence that [Tencent] does not have market dominance in IM."

However, the SPC has not commented on empirical evidence that may call into question the validity of its conclusion. For example, it does not consider : (i) the statistical significance of the observed increase in the monthly coverage of Tencent's competitors ; (ii) the monthly coverage of Tencent also increased during the same time period ; and (iii) "monthly coverage" does not capture the intensity of IM service usage, and "active usage" is a more appropriate measure of competitive significance. In addition, Qihoo 360's economic expert showed there were no statistically significant changes in the share of Tencent's competitors, or that of Tencent, measured in terms of active usage, during the month of the event. The fact that Tencent could substantially lower its product quality and not be adversely affected by it demonstrates Tencent had the ability to freely make business decisions without the threat of losing its customers.

Internet platform competition

The opinion notes the two-sided nature of the market involving the provision of IM (and many other internet-based services). On one side of the market, providers offer specific services (e.g., IM by Tencent and antivirus software by Qihoo 360), often free of charge, as core products to attract users' attention. On the other side, the providers take advantage of the user base built around the core product to profit from upselling value-added services and by selling advertising to firms wanting to reach the user base.

The opinion notes that competition among internet platform providers for users' attention and advertisers is based on the core products these providers offer. The core products differ in terms of their nature, characteristics, functionality, and usage. The SPC notes that even though advertisers may not care about the differences among the core products (as they may only be concerned about the cost of the advertising and its effectiveness in selling products to the user base), and thus may consider different internet platforms as substitutes, the users of the free products would be unlikely to consider the different core products offered by different internet platform providers as close substitutes [6]. Hence, the SPC concludes that the nature and extent of the competition among internet platform providers should not be a factor at the relevant market definition stage of the analysis.

The SPC nevertheless notes the significance of internet platform competition among providers in assessing a firm's market dominance ; in particular, to attract a large base of users, a provider (such as Tencent) has to continue to offer a high quality product. However, while recognizing the innovative and dynamic nature of competition among firms in the internet sector, the SPC focuses on one narrow issue - whether Tencent has taken advantage of its dominant position in IM to eliminate or restrict competition in the provision of antivirus software (thus extending its dominant position in IM into antivirus). The SPC concludes that although the "choose one from two" event had a significant negative impact on Qihoo 360, its impact on consumer welfare was minimal, since users could turn to alternative antivirus products.

In my view, this may have understated the longer run dynamic impact on consumers that the loss of Qihoo 360 may have caused. In focusing on IM and antivirus software, the SPC is potentially overlooking the significance of Tencent's conduct extending beyond the provision of these products. Prior to the "choose one from two" event, Qihoo 360 had a rapidly growing core user base in antivirus software, which it used as a "springboard" to expand into other markets, including markets in which it competed with Tencent (e.g., search, casual online games, and antivirus). Tencent saw Qihoo 360 as a competitive threat, and thus by removing this springboard it could hamper Qihoo's ability to compete with Tencent in its new markets. The "choose one from two" event was successful in undermining Qihoo's core user base in antivirus software (Qihoo lost around 10% of its users within 48 hours). By restricting Qihoo 360 in its core market it could also restrict Qihoo 360 in its ability to compete directly with Tencent in future markets. Furthermore, in addition to directly undermining Qihoo 360, the "choose one from two" event had the added advantage of acting as a clear signal to other competitors that Tencent could, and would restrict rivals who ventured into Tencent's sphere of competition.

Conclusion

The SPC opinion focuses on consumers and the options available to consumers, which is consistent with the basic approach adopted by the US antitrust agencies and courts. This is to be much welcomed, however there are a number of areas in which the opinion may have considered further, and had it done so, may have led to a different decision. First, the opinion does not necessarily distinguish between substitute products that consumers could truly turn to as viable alternatives, and those that consumers are not likely to consider as viable substitutes for Tencent's IM service. Specifically, while the SPC notes there has been entry into the provision of IM services, it has not appeared to consider if entry is fast enough and substantial enough to constrain Tencent's market power. Further, based on the observation that many IM services are available to consumers, and that some of the smaller players have grown over time (measured in terms of the number of unique monthly users), the SPC appears to have concluded that the dominant player must not have market power without recognizing that this does not necessarily have to follow. The SPC also seems to overlook that Tencent is unable to raise price above the current level (or lower quality below the current level) because the current price (or quality) already reflects some degree of monopoly power possessed by Tencent (i.e., the Cellophane fallacy).

Moreover, by downplaying the adverse impact of the "choose one from two" event on Qihoo 360, the SPC has overlooked the ability of Tencent to potentially prevent a growing internet platform provider from creating a network of user base that advertisers find attractive, which is essential for it to become a viable internet platform competitor. Market dominance or market power is defined as the ability of a firm to control price or to exclude a competitor. Evidence of Tencent's ability to exclude Qihoo 360 from the market without suffering from consumer loss is precisely the type of evidence that may be indicative of market dominance.

**Charles River Associates provided assistance to Qihoo 360 in the appeal stage of the matter. The opinions expressed in this article are the author's and do not reflect or represent the views of Charles River Associates or Qihoo 360.*

[1] This is similar to the approach taken by the US Department of Justice and the Federal Trade Commission as detailed in the 2010 Horizontal Merger Guidelines, available at <http://www.justice.gov/atr/public/g...>, accessed on December 22, 2014.

[2] For example, the SPC notes SNS and microblogs focus more on open communications among many users, and less on instant communications. In contrast, IM focuses on private, bilateral communications or internal communications among a small group of users, and its emphasis is on instant communications.

[3] For example, a third-party industry report notes the most important functions for IM users are text, voice, and video chatting, while users of SNS and microblogs place more value on the social functions of these services (e.g., networking with friends, sharing news, expressing oneself, etc.).

[4] IM service is considered a value-added telecommunication service ; as such, the Chinese State Department imposes strict capital and legal requirements on foreign-based firms that wish to offer IM services to users located in mainland China. For example, foreign-based providers are generally not allowed to enter China directly, and can only enter the Chinese market in the form of a joint venture with Chinese firms.

[5] The SPC rules that QQ IM is not an “essential service” to users. Citing the observation that many users use multiple IM services, and that they could build up the network of contacts gradually on different IM products, the SPC concludes that network effects involving IM services are limited and switching costs are low. Hence, there are few economic or technical barriers for users to switch among IM providers.

[6] Further, the SPC suggests that the fact that different core products and services are offered by different internet platform providers may imply that the providers may be targeting different groups of users or advertisers.

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