



ACCC Digital Platforms Discussion Paper



A report prepared for Clayton Utz | 22 July 2022



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Main insights

The Amazon Australia Store has been operating in Australia only since 2017. It faces competition from a range of retailers – including sales through bricks and mortar stores, online sales through traditional bricks and mortar stores, purely online stores and other online marketplaces. This diverse and competitive landscape explains why Amazon is a small retail player with a very low share of the retail spend in Australia.

Because Amazon is a small player and has no significant market power, it can only gain share by competing effectively, innovating, and generating cost efficiencies for the benefit of its customers and suppliers.

The ACCC accepts that success in an industry does not necessarily raise competition concerns where it follows from the firm outcompeting its rivals.¹ However, the ACCC's Discussion Paper floats the idea that it may recommend to Government that there should be changes to Australia's competition law that would impose constraints on the Amazon Australia Store should it reach 'any requisite thresholds linked to market power or strategic/gatekeeper status'. We consider that legislation of this kind is likely to reduce competition in Australian retailing. This is likely for two reasons:

- even in the absence of any uncertainty, the prospect of having regulatory constraints imposed contingent upon some thresholds linked to market power or strategic/gatekeeper status is likely to reduce incentives for all online retailers to compete on the merits, and to favour bricks-and-mortar retailers; and
- the proposal and its implementation will create regulatory uncertainty which will reduce incentives to invest, innovate and undertake other strategies which would otherwise be elements of competing on the merits.

These detriments mean that any *ex ante* regulation in relation to online retailing should only be considered on the emergence of harms and/or a reduction in competition; and regulatory proposals should only be introduced following a cost-benefit analysis.

¹ ACCC, Digital platform services inquiry Interim report, No. 4_General online retail marketplaces, March 2022 (**Interim Report**) p 73.



1 The ACCC Discussion Paper

1.1 The ACCC is considering new regulations for digital businesses

The ACCC has formed the opinion that certain digital businesses are characterised by high barriers to entry due to economies of scale and scope (including in relation to data) as well as significant network effects, and that these have led to certain digital businesses having entrenched powerful positions. The ACCC is concerned that enforcement under existing competition and consumer protection legislation is insufficient to address its concerns arising in relation to rapidly changing digital businesses.²

For these reasons, its Discussion Paper of February 2022 presents a range of possible approaches for changes to current competition and consumer laws to apply to digital businesses. Some of these are consumer protection proposals which should apply universally – not just to digital businesses. Others are proposals which:

... may be appropriate [to] apply only to specific digital platforms. For example, measures to address the consequences of entrenched market power might only need to apply to those large digital platforms with persistent market power. Such platforms could be identified by objective criteria or an assessment linked to their market power and/or strategic position (such as occupying a gatekeeper role).³

The new proposals that the ACCC considers might apply to specific firms to address the consequences of entrenched market power include:

- prohibitions and obligations contained in legislation;
- codes of practice;
- rule-making powers similar to those of the Australian Energy Market Commission;
- measures to promote competition following a finding of competition or consumer harm; and
- access for third parties.⁴

The rationale for these proposals is said to be the harms to competition that the ACCC discusses in chapters 3, 4 and 5 of the Discussion Paper.⁵

² ACCC, Digital Platform Services Inquiry, Discussion Paper for Interim Report, No. 5, Updating competition and consumer law for digital platform services, February 2022 (**Discussion Paper**) p 4.

³ Discussion Paper, p 72.

⁴ Discussion Paper, pp 73-79.

⁵ Discussion Paper, p 72.



1.2 The focus is not online retailers

Chapters 3, 4, and 5 of the Discussion Paper largely focusses on the market power in Australia of certain platforms. The Discussion Paper does not explicitly address the market power of online retailers because, as it stated, "... the ACCC is currently examining general online retail marketplaces in Australia, including eBay, Amazon, Catch.com.au and Kogan, including competition between and within marketplaces and whether any marketplaces hold market power."⁶

The ACCC's examination of general online retail marketplaces in Australia was released in March 2022 as the Interim Report. It discusses the characteristics of online marketplaces and states that the ACCC considers network effects in online marketplaces mean there is a potential for tipping in favour of a single dominant firm, observing that:

In other jurisdictions, including in the United Kingdom, United States and some European countries, the market has arguably already 'tipped' in favour of Amazon, where it has an overwhelming market position in online marketplaces and a strong position in overall online retail. For example, in Italy, Amazon was estimated to account for 20% online sales, and between 70% and 75% of third-party sales on active online marketplaces. As noted above, in the United Kingdom and the United States, Amazon is estimated to account for around 30% and 40% of all online sales, respectively...In a number of these countries, Amazon is subject to anti-trust scrutiny by competition agencies following allegations of anti-competitive conduct by rivals and sellers.⁷

The position of the Amazon Australia store within the Australian retail sector is quite different from its position in the United Kingdom and the United States. As the ACCC observes, the Amazon Australia Store has only recently entered Australia and eBay Australia's share of overall online sales in Australia is currently approximately 10% while the share of the Amazon Australia Store is approximately 2.5%.⁸ However, the ACCC states:

While the ACCC has not identified the same competition concerns with online marketplaces as it has with other digital platform services such as search engines, social media and mobile app online marketplaces, it is important that any

⁶ Discussion Paper, p 21.

⁷ Interim Report, pp 10-11. See also Interim Report, p 83.

⁸ Interim Report, pp 11-12.



framework or set of tools developed be capable of applying to online marketplaces in the future, given the potential for these markets to tip to a dominant firm.⁹

1.3 The proposals could capture Amazon Australia in future

The ACCC suggests that, although the Amazon Australia Store currently accounts for only 2.5% of overall online sales in Australia, there should be changes to Australia's competition law that would impose constraints on the Amazon Australia store should it reach 'any requisite thresholds linked to market power or strategic/gatekeeper status'.¹⁰ Although the ACCC singles out the Amazon store, its proposals for changes in the law apply to all retailers.

We consider that legislation of this kind is likely to reduce competition in Australian retailing. This is likely for two reasons:

- the prospect of having legal or regulatory constraints imposed contingent upon some thresholds linked to market power or strategic/gatekeeper status is likely to reduce incentives for retailers to compete on the merits; and
- the proposal and its implementation will create regulatory uncertainty which will reduce incentives to invest, innovate and undertake other strategies which would otherwise be elements of competing on the merits.

We explain these reasons in the following two sections of this report.

⁹ Interim Report, p 13.

¹⁰ Interim Report, p 81.



2 Australia's retail industry and Amazon

Any assessment of the competitive constraints on online stores should be based on the facts. This section offers a brief overview of the market position of the Amazon Australia Store.

2.1 Distinguishing online and bricks & mortar retailers is wrong

The ACCC's Interim Report analyses competition among exclusively digital retailers independently of hybrid retailers, which operate both online as well as with bricks and mortar stores. The Interim Report draws a distinction between online retail marketplaces and traditional bricks and mortar retailers that also operate online. The Interim Report states:

For the purposes of this Report, a distinction is drawn between online marketplaces and traditional bricks and mortar retailers that also operate online (such as Big W, David Jones, Kmart, Myer and Target). Online marketplaces facilitate transactions between third-party sellers and consumers on a common platform, while traditional bricks and mortar retailers act online as the seller. In this way, online marketplaces take an intermediary role between the consumer and seller, whereas traditional retailers that sell their own products online do not.¹¹

The distinction in this paragraph is misleading in fact and of little relevance to patterns of competition and market power.

It is misleading in fact because the Interim Report classifies the Amazon Australia Store as an online marketplace whereas, in fact,

- it sells products as a retailer in the same way as David Jones and Myer; and
- it provides a marketplace where independent sellers can sell products directly to consumers in the same way as cosmetics and clothing are sold in David Jones and Myer.

Furthermore, the ACCC's distinction between online marketplaces and the online stores of bricks-and-mortar retailers is of little relevance to patterns of competition and market power. The ACCC's distinction appears to be based on the contractual arrangements between the retailer and the manufacturer. This is similar to the distinction in traditional bricks and mortar retailers between retailers who purchase goods from manufacturers and those that sell on consignment. This distinction may be relevant to the analysis of competition in the buying behaviour of the retailers; but it is of little (or no) relevance to the analysis of competition in the selling behaviour of retailers. The final consumer visits a retailer site hoping to find a mix of product and service

¹¹ Interim Report, p 16.



that is attractive. The formal contractual relationship with the retailer is of little consequence to the final consumer.

The absence of any significant difference to the purchaser is clear from Table 1.1 on pages 18-19 of the Interim Report. The Table lists the characteristics of selected online marketplaces and other retailers. The Table indicates that there are no systematic differences in the selling activities of those retailers who sell only online and the online selling activities of those retailers which also sell via a bricks and mortar store.

As the Interim Report indicates, the Amazon Australia Store accounts for a relatively small percentage of online general retailing in Australia:

As Figure 1 shows, out of the four major online marketplaces in Australia, eBay Australia (the first major online retail marketplace to be established in Australia) remains the largest with annual sales of over \$5.3 billion in 2020–21. This is followed by Amazon Australia with \$1.3 billion.

These figures should be considered in the context of total online sales in Australia which were estimated at more than \$52 billion in 2021. eBay Australia's share of overall online sales in Australia is currently approximately 10% while Amazon Australia's share is approximately 2.5%.

By way of comparison, Kmart and Big W, both large retailers with online and offline sales channels, had annual sales of almost \$6.9 billion and \$4.6 billion respectively in 2020–21. Annual sales for each of Amazon Australia, Catch and Kogan are currently lower than the major established Australian retailers.¹²

Amazon Australia Store faces tough competition in its retailing operations in Australia. The retail sector is dynamic and could not be described as falling short of highly competitive. As the Amazon Australia Store has no significant market power, its growth and profit must be the result of competition on the merits rather than the exertion of market power. The Amazon Store must compete by generating value for Australian consumers.

The ACCC's Interim Report states:

The ACCC considers a major factor which has driven Amazon's rise overseas has been its ability to innovate and provide services that consumers want, and to harness the power of network effects and consumer data. In addition, Amazon's significant investments in distribution, delivery and other areas, at the expense of

¹² Interim Report, pp 11-12.



short-term profits, have provided it with significant first mover and scale advantages.¹³

As the Interim Report accepts, the Amazon Australia Store has no first-mover or scale advantages. The other reasons given in the paragraph for the success of the Amazon Store in other jurisdictions relate to economic efficiency. If the Amazon Australia Store is to succeed, it will do so because it contributes to the economic efficiency of Australian retailing.

2.2 The need for growth and scale

Amazon Australia opened its retail store in Australia in 2017. As the ACCC's Interim Report suggests, the development of Amazon Australia Store has been accompanied by significant investment. On 6 April 2022, Amazon stated:

Since we launched in Australia, Amazon has invested over \$5.3 billion across its businesses including retail, Prime Video, Audible and Amazon Web Services. This investment includes building state-of-the-art fulfilment centres and logistics sites in Sydney, Melbourne, Perth, Brisbane, Adelaide, Gold Coast and Newcastle to store and ship products quickly to customers, and data centres and corporate offices to support businesses of all sizes across the country with cloud computing.

In the past year, Amazon has invested more than \$1.9 billion invested across all its businesses in Australia.¹⁴

Much of this investment involves incurring costs (such as setting up online systems, warehousing and logistics) which are relatively fixed with respect to its sales. For its business to be profitable, Amazon has to spread these fixed costs over a large volume of sales.

For this reason, the profitability of the Amazon Australia Store depends on its ability to increase its sales. To do this, it needs to do its best to maximise the value it creates for consumers – by lowering prices, improving service and otherwise innovating to deliver things to consumers in new and different ways.

In summary, Amazon hopes to expand its business in Australia; but any expansion that it might be able to make will be contingent upon its ability to compete on the merits – that is, to create efficiencies for the benefit of consumers.

¹³ Interim Report, p 83.

¹⁴ <https://www.aboutamazon.com.au/news/economic-impact/amazons-continued-investment-in-aussie-jobs-and-businesses>, accessed on 9/06/2022.



3 New regulations will reduce incentives for competition on the merits

3.1 New regulations may be recommended

Section 6.2 of the Issues Paper presents the ACCC's argument for change in Australia's competition law. It argues that the existing law is not sufficient to deal with digital firms. It states:

In relation to the CCA, the ACCC considers that existing provisions alone may not be sufficient to address the harms to consumers and competition arising from the significant and entrenched market power of the large digital platforms, particularly where effective competition is no longer possible...

In our opinion, the ACCC has been vigilant in prosecuting firms for breaches of consumer law; however, it has not pursued digital firms to trial for breaches of competition law. It cannot argue that our laws applying to firms with significant and entrenched market power are insufficient to deal with digital firms when the ACCC has not pursued these firms to trial.

As we observed in section 2 above, while the ACCC's proposals target specific firms which the ACCC says have significant and entrenched market power, the ACCC nonetheless urges that it is important that any framework or set of tools developed be capable of applying *ex ante* to online marketplaces that may achieve significant and entrenched market power in the future. The ACCC singles the Amazon Australia Store out for special mention, although the ACCC's own analysis indicates any likely growth of the Store will be attributable to its generation of economic efficiencies.

3.2 Ex-ante developments

The Discussion Paper gives two examples of *ex ante* regulation: legislation in Germany and the EU Digital Markets Act (DMA). The Discussion Paper also looks at the proposed development of "specific rules" and frameworks in the United Kingdom. Finally, the ACCC refers to developments in Japan (where transparency regulation adopts a co-regulatory model) and South Korea (where regulation has taken a sector specific approach).¹⁵

The legislation referred to as the EU DMA designates 'gatekeepers' who are providers of 'core platform services'. A provider of core platform services would be designated as a gatekeeper if it

¹⁵ Discussion Paper, Box 8.1, pp 84-85.



met certain quantifiable criteria or if the criteria were not met, following a separate investigation by the European Commission (EC). The criteria are:

1. it has a significant impact on the internal market of the EU: i.e., it operates core services in at least 3 EU Member States and achieved an annual turnover in the European Economic Area of or above €7.5 billion in each of the last three financial years or has an average market capitalisation or market value of or above €75 billion;
2. it operates a core platform service that serves as an important gateway for business users to reach end users: i.e., the service has over 45 million monthly active end users in the EU (roughly 10% of the population of the EU) and more than 10,000 yearly active business users in the EU in the last financial year; and
3. it enjoys an entrenched and durable position in its operations, or it is foreseeable that it will enjoy such a position in the near future.¹⁶

If these criteria were met, then the provider would automatically be designated as a gatekeeper unless the designation were successfully challenged. The DMA provides for a set of constraints on all gatekeepers in their interactions with business users, final customers and competitors.

As we observed above, the ACCC's Discussion Paper suggests that in some cases, it may be appropriate that new measures apply only to specific digital firms and that such firms could be identified by objective 'thresholds linked to market power or strategic/gatekeeper status'. The ACCC does not elaborate on whether these thresholds might be like those in EU, Germany or something else.

3.3 The likely effect on competition on the merits

The introduction of *ex ante* regulation in a form that would be capable of applying to online marketplaces that are currently operating in highly competitive sectors is particularly bad economic policy. As we discuss in section 4 below, it is bad economic policy because it creates a great deal of uncertainty (about the thresholds and about the application of specific prohibitions); and it is bad economic policy because of its effects on competition on the merits.

The introduction of *ex ante* regulation in a blanket form that could be applied to firms that are currently operating in highly-competitive retail sector will create a disincentive for those firms to compete on the merits. If firms compete on the merits and thereby gain volume and/or share, they should not be penalised – because the prospect of their being penalised will reduce the incentive for them to compete on the merits.

As John Vickers writes: "... non-dominant firms need assurance, so that their competitive conduct is not chilled and they are not at risk of findings, or even investigations, of abuse."¹⁷

This reasoning is fundamental to the theory of competition policy. It is the reason why the mere acquisition of market power has never been an offence in the United States or Australia. In the famous words of Judge Learned Hand in the *U.S. v. Aluminium Co. of America*:

¹⁶ Discussion Paper, Attachment A, pp 111-113.

¹⁷ John Vickers, "Market Power in Competition Cases", *European Competition Journal*, Vol 2, Sup 1, 2006, pp 3-14 at p 12.



A single producer may be the survivor out of a group of active competitors, merely by virtue of his superior skill, foresight and industry. In such cases a strong argument can be made that, although the result may expose the public to the evils of monopoly, the Act does not mean to condemn the resultant of those very forces which it is its prime object to foster: finis opus coronat. The successful competitor, having been urged to compete, must not be turned upon when he wins.

The disincentives would create distortions of various kinds; and they would not be confined to the Amazon Australia Store:

- they would favour bricks and mortar suppliers over digital suppliers; and
- they would favour the bricks and mortar arms of hybrid suppliers over their digital arms – to the extent that their digital arms were caught.

Competition is favoured by economists principally because it promotes economic efficiency. The importance of competition for the efficient allocation of resources was acknowledged by the Trade Practices Tribunal (as it then was) in *Re QCMA and Defiance Holdings* (1976) ATPR 40-012 where it states:

Competition may be valued for many reasons as serving economic, social and political goals. But in identifying the existence of competition in particular industries or markets, we must focus upon its economic role as a device for controlling the disposition of society's resources. Thus we think of competition as a mechanism for discovery of market information and for enforcement of business decisions in the light of this information. It is a mechanism, first, for firms discovering the kinds of goods and services the community wants and the manner in which these may be supplied in the cheapest possible way. Prices and profits are the signals which register the play of these forces of demand and supply. At the same time, competition is a mechanism of enforcement: firms disregard these signals at their peril, being fully aware that there are other firms, either currently in existence or as yet unborn, which would be only too willing to encroach upon their market share and ultimately supplant them.¹⁸

We respectfully suggest that the ACCC carefully consider this passage from QCMA. The application or threat of application of *ex ante* regulation to firms in the retail sector, a sector which is highly-competitive, will distort the efficient allocation of resources. The application of *ex ante* regulation in a highly-competitive sector like retail is anti-competitive because the distortions it causes detract from the very results that we hope for from the process of competition.

¹⁸ QCMA, p 17,245.



4 New regulations will create regulatory uncertainty

In Section 3, we suggested that pre-emptive ex-ante regulation applicable to the retail sector to address the possibility of harms will create disincentives for competition. The ways in which these disincentives will most obviously arise are through disincentives to invest and innovate.

The strength of the disincentives will depend on the perceptions of firms possibly affected by the regulation. Uncertainty arises because firms must predict the effects of regulations. The classic definition of uncertainty is a lack of quantifiable knowledge about some possible occurrence, as opposed to the presence of quantifiable risk.¹⁹ By "regulatory uncertainty", we mean the concept of uncertainty perceived by a firm as a result of not being able to adequately predict the regulator's decisions and their effect on the firm's commercial environment.

The uncertainty that is created by the any of the ACCC's competition proposals is likely to be a key cost in an assessment of the costs and benefits of applying regulation to firms at some future point. In this section, we document what we think are the likely sources and effects of regulatory uncertainty on (i) investment and (ii) innovation.

4.1 There are several sources of regulatory uncertainty

Proposals of the kind being considered by the ACCC would create regulatory uncertainty in the form of:

- the nature and level of the thresholds of the kind discussed in section 3.2;
- the application of the specific prohibitions;
- whether and how the thresholds or prohibitions might change; and
- costs of complying with the prohibitions.

Uncertainty concerning the nature and level of the thresholds

Uncertainty regarding the application of prohibitions contingent upon breach of a threshold might be thought to be limited. But in practice this is unlikely to be the case because some discretion will almost inevitably be required:

- Proposals that would be the most sensible from an economic perspective cannot easily be defined in objective terms. For example, thresholds related to enduring market power over a 'bottleneck' input might be analysed, but this is clearly not a straightforward process and would require judgement on a range of relevant structural, conduct and performance indicators.²⁰ The application of the Part IIIA declaration criteria for regulated access provides

¹⁹ Knight, F. H. (1921) Risk, Uncertainty, and Profit. Boston, MA: Hart, Schaffner & Marx; Houghton Mifflin Company.

²⁰ The judgement in *Application by Chime Communications Pty Ltd (No 2)* [2009] ACompT 2 (27 May 2009) highlights the difficulties in defining market competitiveness (20-54) and the identification of market power (84-87). In considering earlier cases on market power, the Tribunal refers to *Queensland Wire*: "[87] Queensland Wire makes it plain that there are several indicia of market power, and none may be conclusive in a particular case."



some indications that thresholds, however well-conceived, are difficult to apply and inevitably gives rise to uncertainty in their application, as shown by the Part IIIA criteria having been subject to numerous High Court cases and a number of legislative revisions since first being developed in 1995.²¹

- Proposals that are easier to define have the benefit of greater objectivity, but they may make little economic sense. For example, thresholds related to revenue or number of users may be measurable but uncorrelated with enduring market power; for example, revenues are affected by matters such as product mix, and it is rarely clear how one should define a “user” and, in our experience, companies use many different definitions.

Uncertainty concerning the application of specific prohibitions

The most obvious form of uncertainty is what effect the rules will have once they are in place and the firm or firms are subjected to them. How tightly will they constrain conduct that has previously been a source of competitive advantage? Of course, the effect of this uncertainty is very difficult to predict now because it depends on what the rules are and how vigorously they will be enforced. We cannot analyse this uncertainty without further details of the specific rules, detail that is lacking from the ACCC’s Discussion Paper.

Uncertainty regarding changes in the thresholds or the prohibitions

Once the thresholds and prohibitions are in place, further uncertainty will arise about whether they will change. That might be particularly concerning if there is a perception that prohibitions will be further developed over time. For example where the regulator has rule making powers or if the “broad-brush” rules require the regulator to give effect to processes or procedures which could be amended at any time, or where the proposals do not immediately have the desired effects.

Uncertainty regarding costs of complying with the prohibitions

Compliance costs are the costs to firms of complying with the regulations and can include costs such as the costs of reporting compliance, costs of training employees about regulatory obligations, and costs of delay through waiting for a regulatory decision. Uncertainty arises because we do not know how large these costs might be without further knowledge of the rules.

4.2 The effects of regulatory uncertainty on investment

4.2.1 Regulatory uncertainty affects investment by platforms and complementors

The ACCC appears to be alive to the impact of uncertainty on investment generally. However, it chooses to highlight the effect of uncertainty created by a dominant digital firm on investment incentives on a platform’s users rather than focus on uncertainty created by unwarranted or excessive ex-ante regulation:

²¹ A useful summary of these changes is in Chapter 7 of Peterson et al, *Access Regulation in Australia*, Thomson Reuters, 2016.



In particular, the ACCC has concerns where a dominant digital platform is able to unilaterally and adversely change the terms and conditions for a business user... This action – or even the threat of such action – allows the platform to ‘appropriate’ some of the value of the sunk investments made by the business (such as costs associated with making their services compatible with the platform), which in turn can undermine the incentives for future investment. This can create uncertainty for businesses, and lead to inefficient investment decisions. It can also unduly restrict or prevent the emergence of alternative business models.²²

We agree with the ACCC that there is a conceptual case that uncertainty can lead to inefficient investment decisions and harm competition. The primary investment concern that is associated with sunk investment and referred to by the ACCC is the ‘hold up’ problem. Producers of complementary products to a digital firm may be less willing to invest in costs that will become sunk if these producers are subject to appropriation by the platform.

Whether this type of appropriation is likely depends on the nature of investments made by complementors. It is by no means obvious that complementors to the Amazon Australia Store make the kind of investments that could be appropriated, as there are few specific investments required to sell on the Amazon Australia Store.

Nonetheless, the point which we wish to highlight is that uncertainty does not just hinder investment and competition *downstream or upstream* of the regulated firm – it would apply equally to the Amazon Australia Store captured by the regulations.²³ The discussion paper does not appear to give any weight to concerns related to the effect of regulatory uncertainty on investment. A well-balanced assessment of regulation would also note that:

- firms themselves may be unwilling to invest if their successful business model is suddenly constrained by regulation;
- firms may prefer to invest less to preserve options once more is known about the likely effects of regulations; and
- complementors to firms may invest less than expected if the regulations are unclear or uncertain in their application.

The first effect relates to the familiar regulatory truncation problem that has been widely analysed in regulation of utility pricing. If an investment is unsuccessful in generating demand and a return on investment, the firm bears the loss; but if the investment is successful then regulation binds which reduces the return on investment to a “normal” level. The expected value

²² Discussion Paper, pp 54-55.

²³ This point is recognized in the paper cited by the ACCC, see D. Biggar and A. Heimler, Digital Platforms and the Transactions Cost Approach to Competition Law, August 2, 2021, available at SSRN: <https://ssrn.com/abstract=3934925>.



or mean return of such investments, which is calculated by multiplying the probability of each outcome by its return, is reduced and this creates disincentives to invest.²⁴

Such concerns are particularly acute for businesses that are effectively start-ups, not incumbents. In Australia, Amazon's Store is a new competitor entering long after eBay and facing intense competition. Investment decisions are finely balanced. Regulatory measures that would add costs and reduce returns in response to competitive success matter for investment decisions now.

On the second point, the possibility of regulation makes it harder to predict investment returns on successful investments. That is, predicting the likely return from an investment would require predictions of returns that might arise from the application of new regulatory rules in future. If investments are irreversible at low or no cost, a profit-maximising response to such uncertainty is to defer or delay investment until more is known. This is referred to as a "real options" effect; there is value in taking steps to delay where investments are irreversible and can be undertaken in stages.²⁵ If the investment would otherwise have taken place in full then it is an additional cost of regulatory uncertainty.

4.2.2 The empirical evidence on regulatory uncertainty and investment

As illustrated in the previous section, the economic literature connects uncertainty and investment in various ways. There is also an empirical literature connecting uncertainty generally with investment. This literature is said to provide suggestive but not conclusive evidence that uncertainty damages short-run growth, by reducing output and investment.²⁶ In part this reflects standard empirical challenges, such as separating uncertainty as a cause of reduced investment, and measuring uncertainty. It is therefore not surprising that the empirical literature on the impact of regulatory uncertainty on investment is relatively sparse and limited to specific policy issues such as investment in renewable energy and trade policy.²⁷

From this literature, there are papers such as Fabrizio (2012) that find that, in the context of varying US State regulations to promote new renewable energy sources, perceived regulatory instability reduced new investment and undermined policy goals.²⁸ There is also a recent literature that highlights the potential for regulatory uncertainty to deliver poor economic outcomes with effects

²⁴ Regulators alive to such outcomes can mitigate the effects of truncation on average returns; for example, by committing to allow for higher returns on successful investments, or as suggested in the regulation of access infrastructure allowing for an "access holiday" as in Joshua S. Gans & Stephen P. King, 2004. "Access Holidays and the Timing of Infrastructure Investment," *The Economic Record*, The Economic Society of Australia, vol. 80(248), pages 89-100. But it is undoubtedly very tempting to overlook the true risks involved in making the investment (*ex ante*) after it is already successful (*ex post*).

²⁵ N. Bloom, "Fluctuations in Uncertainty", *Journal of Economic Perspectives*, Volume 28, Number 2, Spring 2014, p. 163.

²⁶ Summarised in N. Bloom, *op. cit.*, p. 168.

²⁷ See Carballo et al, *Economic And Policy Uncertainty: Export Dynamics And The Value Of Agreements*, NBER Working Paper 24368, available at <http://www.nber.org/papers/w24368>. Carballo et al state that: "The impact of uncertainty on firm investments is theoretically understood and there is growing empirical evidence for this mechanism. However, the evidence is scarcer when it comes to policy uncertainty [of which regulatory uncertainty is one kind]... The scarce evidence is partly due to the difficulty in measuring policy uncertainty, identifying its causal impact on specific investment decisions, and unbundling it from economic uncertainty."

²⁸ Fabrizio concludes that "firms may be unwilling to invest in assets that are long-lived and location- and policy-specific in environment with significant regulatory uncertainty". K. Fabrizio, "The Effect of Regulatory Uncertainty on Investment: Evidence from Renewable Energy Generation" *Journal of Law, Economics, & Organization*, August 2013, Vol. 29, No. 4 (August 2013), pp. 790-791.



on output and employment on a macro scale. That is, the studies identify economy-wide regulatory uncertainty and map this to aggregate economic indicators. A recent paper in this literature by Sinclair and Xie (2021)²⁹ analyses regulatory uncertainty using measures derived from a large body of news references, with text-based analysis.³⁰

The results of the analysis highlight that both negative sentiments and uncertainty about regulation have measurable effects, although sentiment effects appear longer lasting:

Impulse response functions indicate that a negative shock to sentiment about regulation is associated with large, persistent drops in future output and employment, while increased regulatory uncertainty overall reduces output and employment temporarily.³¹

Bonaime et al (2018) apply a similar empirical approach using uncertainty indexes to highlight the negative relationship between uncertainty and mergers & acquisitions activity³², while Clougherty and Zhang (2021) identify relationships between merger policy uncertainty and foreign direct investment.³³

4.3 The effects of regulatory uncertainty on innovation

Innovation is an important feature of digital businesses and the ACCC agrees that a factor which has driven Amazon's rise overseas has been its ability to innovate and provide services that consumers want.³⁴

Competition provides an incentive for existing firms and entrants to innovate to increase their sales. We would suggest that competitive innovation is more salient in online retailing because:

- (i) Customers of online retailers face very low switching costs between different retailers, with the ACCC's report finding that "...there is a high degree of multi-homing...This is likely

²⁹ Sinclair and Xie, *Sentiment and Uncertainty about Regulation: Working Paper*, GWU regulatory studies center, June 25 2021. A further paper in a similar tradition which measures economic policy uncertainty is S. Baker, N. Bloom, and S. Davis, "Measuring economic policy uncertainty", *The Quarterly Journal of Economics*, 2016, 131(4):1593–1636.

³⁰ The first measure is the general sentiment expressed regarding regulation, which covers whether there is a positive or negative tone of the article and its strength. The second measure is the degree of uncertainty expressed in the news about regulation. The authors analyse both measures (developed as indexes using a regression methodology) against macroeconomic outcomes such as output and employment.

³¹ Sinclair and Xie, op. cit., , p. 1.

³² A. Bonaime, H. Gulen & M. Ion, "Does policy uncertainty affect mergers and acquisitions?", *Journal of Financial Economics*, Vol. 129, Issue 3, September 2018, pp. 531-558.

³³ J. Clougherty and N. Zhang, "Foreign investor reactions to risk and uncertainty in antitrust: U.S. merger policy investigations and the deterrence of foreign acquirer presence", *Journal of International Business Studies*, 52, 2021, pp. 454-478.

³⁴ Interim report, p. 83.



to be due, in part to many consumers facing very low or no costs to using multiple online retail options and switching between them.”³⁵

(ii) Online retailers already compete with a range of other well-established retailers.

Innovation in the retail sector will therefore continue to be critical to building and sustaining competitiveness though providing a better consumer experience from increased product variety, faster delivery speed and greater reliability.

In that context, the possible effect of uncertain regulations on innovation is of particular importance to online retailers in Australia. The mechanism by which uncertainty reduces innovation is similar to investment generally – that regulation can limit the return to innovations and so firms will either reduce innovation or delay innovating until there is more certainty.

The threat of regulations that might slow the pace of innovations in online retailing are likely to be particularly costly because (i) they would reduce consumer benefits but also (ii) they would apply asymmetrically and thus favour firms that fell outside of the regulation. That is, regulations will limit the ability of businesses to compete if it provides an advantage to some businesses over others, or significantly raises costs for some businesses relative to others. For example, this could occur if digital ex-ante regulation is introduced and affects the Amazon Australia Store, but not other retailers.

Finally, we note that the literature on innovation offers little in the way of support for specific regulatory interventions:

- A suggestive experimental study of the effects of the DMA and incentives to innovate was undertaken for Amazon by Oxera at the University of Vienna.³⁶ The study indicated that the DMA was likely to reduce the total amount of innovation in high digital intensity industries, which are among the main contributors to European growth.
- The CMA’s 2020 study of competition and innovation finds that greater regulation is – on average – associated with lower competition, and that there are important gaps in knowledge on the effects of specific regulations on innovation.³⁷
- Specific studies of regulation and innovation, such as Aghion et al (2019) and Stern (2017), have found that regulation has deterred innovation.³⁸ In Aghion et al’s paper, the cause is labour regulations and the effect is lower patent activity (as a proxy for innovation), and in Stern’s paper the cause is regulation of medical devices and the effect is higher costs for innovation and favouritism of larger firms.³⁹
- Relating more specifically to competition and digital markets, a study by the Centre for Competition Policy for the UK Government (2021) highlights that the “theoretical literature on competition and innovation is well known for the variety and complexity of the incentives at

³⁵ Interim report, p. 79.

³⁶ Oxera Consulting, *The Digital Markets Act and incentives to innovate*, 2021, available at: https://www.oxera.com/wp-content/uploads/2021/05/The-Digital-Markets-Act-and-incentives-to-innovate_final.pdf.

³⁷ CMA, *Regulation and Competition: A Review of the Evidence*, CMA 111, January 2020, pp. 39-40.

³⁸ P. Aghion, A. Bergeaud and J. Van Reenen, *The impact of regulation on innovation*, NBER Working Paper 28381, 2021, available at: <https://www.nber.org/papers/w28381>.

³⁹ A. Stern, “Innovation under Regulatory Uncertainty: Evidence from Medical Technology”, *Journal of Public Economics*, 2017, 145, pp. 181-200.



play” and there is limited peer-reviewed empirical evidence from digital sectors focussed specifically on the empirical evidence on the relationship between competition and innovation.⁴⁰

⁴⁰ D. Deller et al., *Competition and Innovation in Digital Markets*, BEIS Research Paper Number: 2021/040, Executive Summary.

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