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Qihoo v. Tencent: economic analysis of the first Chinese Supreme Court decision under Anti-Monopoly Law*

The October 16, 2014 Chinese Supreme People's Court (SPC) decision on *Qihoo 360 v. Tencent* marked the SPC's first ruling on a matter filed under China's Anti-Monopoly Law (AML). The decision was particularly notable because although the SPC affirmed the decision of 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, it differed sharply with the approaches taken by the High Court, particularly with respect to the definition of the relevant markets.

This note first provides a brief background on the dispute between Qihoo 360 and Tencent central to this litigation. It discusses two key points in the SPC's opinion: (i) the SPC's criticism of the High Court's definition of the relevant markets and its de-emphasis of market share 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. While we 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 decisions based on competitive effects analysis. This 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. Each builds its user base via a free core product: antivirus software (Qihoo 360) and the QQ instant messaging (IM) software (Tencent). Both companies profit from selling online advertising and offering "value-added" services to users. However, conflicts between Qihoo 360 and Tencent broke out in 2010 when Qihoo 360 introduced its 360 Bodyguard software allowing users to control the number of ads that

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QQ's IM software could display. Tencent responded by making its QQ IM software incompatible with all Qihoo software, with users being forced to choose between having QQ IM or Qihoo's antivirus software on their computer (the "choose one from two" event). Within the space of 48 hours, Qihoo 360 lost around 10% of its users. The subsequent public outcry resulted in the Ministry of Industry and Information Technology (MIIT) intervening to broker an agreement. Qihoo 360 agreed to discontinue its 360 Bodyguard software, whilst Tencent agreed to reinstate compatibility with Qihoo software.

Qihoo 360 filed a complaint against Tencent 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 has 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 subsequently appealed the High Court's ruling, and the case was heard in front of the SPC in November 2013.

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

The SPC decision first criticized the High Court's use of the "small but significant and non-transitory increase in price" (SSNIP) test in coming to a wide relevant market definition. The SPC noted that when the price of a product is zero, as in the case of IM services, 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." Thus, contrary to the High Court, the SPC indicated that using the hypothetical monopolist test (HMT) based on a "*small but significant and non-transitory decrease in quality*" (SSNDQ), as opposed to the commonly used SSNIP test, would have been more appropriate given the product's lack of price.

Second, contrary to the High Court, the SPC emphasized that relevant market definition should focus on demand-side substitution factors evaluated from the point of view of the consumers located in mainland China.¹ The SPC rejected the High Court's product market definition which included "at least IM, social networking services ("SNS") and microblogs." The SPC notes that SNS and microblogs, and IM products serve different consumer needs, and criticized the High Court for ignoring these demand-side differences. In particular, the SPC is especially 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.

Third, with regards to geographic market, the High Court had ruled that the relevant geographic market was worldwide, on the basis that foreign-based IM service providers offered services to users located in mainland China, and Tencent's IM service was available to users located outside of China. However, the SPC again concluded this approach was incorrect. It noted that the focus of relevant geographic market definition should not be whether it is feasible, but whether or not foreign-based suppliers can and will enter China in a timely manner and act as effective competitive constraints in response to a small change in relative product quality (SSNDQ) of the IM services available to users in China. Recognizing that the legal and regulatory restrictions imposed on foreign-based providers present real entry barriers in the provision

¹ This is similar to the approach taken by the US Department of Justice and the Federal Trade Commission as laid out in the 2010 Horizontal Merger Guidelines issued by the agencies on August 19, 2010, available at <http://www.justice.gov/atr/public/guidelines/hmg-2010.html>.

of IM services in China,² the SPC logically concluded that the High Court had erred, and the relevant geographic market is mainland China only.

Even on the basis of this more rigorous market definition, the SPC cautioned that market share is a rough and potentially misleading indicator of a firm's market dominance. Despite Tencent's persistently high market share in the relevant market (more than 85% in terms of active usage), the SPC noted that since competition in the provision of IM services was highly dynamic, the boundary of the relevant market was not as clear as that of more "traditional" markets. Thus the SPC stressed that, 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

The SPC considered evidence of entry and expansion as playing a pivotal role in its conclusion that Tencent does not have a dominant position in the provision of IM services in China. In coming to this conclusion the SPC noted that the large number of alternative IM services available to users at the time of the dispute, and the rapid growth of some of the recent entrants, *measured in terms of the number of unique monthly active users ("monthly coverage")*, implied users can readily switch to these alternative IM services.³ However, perhaps surprisingly, the SPC did not appear to consider the relative scale of the entrants. For example, the SPC downplayed the empirical evidence presented at trial showing that even in the face of entry, Tencent was able to persistently maintain close to 90% market share. This lack of ability of competitors to increase their shares fundamentally questions the relevance of increasing overall market growth as evidence of a lack of dominance.

In order to inform its view on dominance, the SPC considered whether there was direct evidence to evaluate a defendant's market position and the competitive effect of the complained of conduct. The "direct evidence" the SPC focused on was the impact that the "choose one from two" event had on competitors. The SPC found that the monthly coverage of competitors showed a higher than average increase during the "choose one from two" event, and along with the observation of a few IM providers engaging in promotional activities around the same time of the event, concluded this was "convincing evidence that [Tencent] does not have market dominance in IM."

However, the SPC did not comment on the statistical significance of this direct evidence. Specifically the SPC did not appear to consider analysis presented by Qihoo 360's economic expert that showed there were *no statistically significant changes* in either the share of Tencent's competitors, or that of Tencent during the month of the event. The fact that Tencent could substantially lower its product quality and not

² 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.

³ The SPC ruled that QQ IM was 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 concluded 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.

see an adverse quantity reaction by users demonstrates Tencent had the ability to freely make business decisions without the threat of losing its customers.

Finally, the SPC considered 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 offered specific services (e.g., IM with Tencent and antivirus software with Qihoo 360), often free of charge, to users as core products to attract users' attention. On the other side, the providers take advantage of the user base to upsell value-added services and sell advertising to firms wanting to reach the user base.

The SPC recognized the significance of internet platform competition among providers, in particular, to attract a large base of users. In considering this, the SPC gave significant weight to whether there was likely to be a negative impact on consumers, concluding 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.

This may have understated the impact on consumers the loss of Qihoo may have caused. In focusing only 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 directly with Tencent (e.g., search, casual online games, and antivirus). Tencent saw Qihoo 360 as a competitive threat, and 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's 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

Unlike the High Court, the SPC opinion focused on consumers and the options available to consumers, which is consistent with the basic approach adopted by the antitrust agencies and courts in the US. While it is welcomed, however, there are a number of areas in which the opinion could have considered further, and had it done so, may have led to a different decision. First, the opinion could have done more to distinguish between substitute products that consumers would turn to as viable alternatives, and those that consumers were unlikely to consider as viable substitutes for Tencent's IM service. Specifically, although the SPC notes that there has been entry into the provision of IM services, it has not appeared to consider whether the entry is fast enough and substantial enough to constrain Tencent's market power. Second, while we agree with the importance of considering direct evidence, it is important to subject such evidence to robust statistical analysis. Failure to do this may have led the SPC to underestimate the adverse impact of the "choose one from two" event on Qihoo 360, thereby overlooking the ability of Tencent to potentially prevent a growing internet platform provider from creating a user base from which it could expand into direct competition with Tencent. The fact that Tencent had the ability to significantly reduce Qihoo 360's position without suffering consumer losses is precisely the type of evidence that may be indicative of market dominance.

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