

## ICN Curriculum Module III-2 From Complaint to Intervention in Abuse of Dominance Cases A Case of Predation

### Virtual Reality Consoles - Hypothetical Case Study

Domco and Entco are the only two companies that produce virtual reality consoles (VRCs), a new type of gaming platform that is growing fast. Domco, the first VRC producer, has the majority of VRC sales, while Entco, a recent entrant, has a much smaller share. Domco's main product is based on its own proprietary "delta" standard, while Entco's console uses the open "gamma" standard. Neither standard is technologically superior.

- Domco's VRC consoles, based on the delta standard, were according to financial reports highly profitable at price of \$459 per unit.
- After Entco entered the VRC market with its gamma-based console at \$399 per unit, Domco's market share began to decline.
- Subsequently, Domco began producing a new VRC based on the gamma standard, which it sold at \$330. Evidence suggests that that price is well below both the average total costs associated with developing and commercializing as well as manufacturing Domco's gamma console and those of Entco's gamma console.
- Domco's gamma console has taken share from Entco, leading Entco to respond by dropping its gamma unit price from \$399 to \$325 per unit. Entco's market share loss has raised its per unit manufacturing costs (from \$300 to \$310 per unit; it has also led Entco to raise its promotional/advertising expenditures from \$30 to \$50 per unit). However, Domco's launch of its gamma console also has taken sales from Domco's delta console. In other words, Domco's gamma console has "cannibalized" Domco's delta console to some extent.

Entco filed a complaint with a competition agency against Domco claiming that Domco is abusing its dominant power in the VRC market by engaging in a number of exclusionary practices including selling gamma consoles at a predatory price.

Domco claims that its prices cover variable costs, that its costs will fall further as sales volumes increase and that this is a rapidly evolving market with the next generation of machines, Ultimate Reality Consoles, already being talked of.

The competition agency has obtained some data and some non-public Domco documents that may shed some light on Domco's business practices.

Data on product and costs:

- The consoles are made from components that are manufactured by other firms, and are sourced by Domco and Entco at the same prices. The gamma consoles of Domco and Entco are made from somewhat cheaper/lower quality materials but are functionally equivalent to the Domco delta console.
- Console producers, Domco and Entco, engage in the design of the console, the assembly processes and the software, as well as the marketing of the products. The R&D and commercialization costs are sunk.
- Manufacturing costs involve both variable (essentially components and materials) and semi-fixed costs in setting-up and running the assembly facility with the machines required. The facilities and machines required are not specific to VRCs, however, and production could conceivably be done on a contract assembly basis.
  - Domco's manufacturing costs (variable and fixed) for the Delta console are \$320 per unit
  - Entco's manufacturing costs (variable and fixed) for the Gamma console are \$300 per unit before the entry of Domco Gamma, after which they increased to \$310 per unit due to the effect on average costs of somewhat lower volumes.
  - Domco's manufacturing costs for the Gamma machine are \$260 if only materials and components are taken into account, or \$450 taking into account the fixed costs of the manufacturing facility given the relatively low sales volumes to date.
- Promotion and adspend is important for customer awareness, acceptance and brand building. It can be broken down into promotional displays for retail outlets etc. which is committed in advance, and ongoing monthly advertising the magnitude of which can be varied easily on short notice.
  - Domco's adspend on its Gamma machine is an average of \$60 per unit, although they claim only \$10 per unit is easily varied at short notice.
  - Entco's adspend was \$30 per unit, increased to \$50 per unit after the entry of Domco's Gamma machine.

- Domco's adspend on the Delta machine averages \$30 per unit, although it is a much larger overall spend given the much bigger sales of Delta.

Delta claims that its variable costs for its Gamma console in terms of those that vary directly with the number of units produced in any given month amount to \$260 for components and materials, plus \$10 of adspend. At a price of \$330 it is covering these costs.

Taking the decision to continue producing Gamma or to cease production, the costs that would be avoided on a per unit basis are \$300 from manufacturing costs (saving some of the costs categorized as fixed) and \$40 of promotion and adspend (that is, totaling \$340). It is currently not covering these costs.

### **Statements Made by Domco Officials in Non-Public Business Documents Obtained by the Competition Agency**

- Around launch of first VRCs: *“at all costs we must prevent open standards emerging for VRCs, as then we can lock-in users and game designers. VRCs are our ‘Delta station’.”*
- Preparing for launch of gamma console: *“By entering the gamma space we risk giving it credibility. And, while ‘Domco is VRCs’, we will support lower priced offering while, over time, effectively degrading it by ensuring that the incremental technological improvements are in Delta, and game designers will want to work for this standard.”*
- *“Charging low prices for our gamma console will suggest that our costs are very low, even although in the short run we will lose some Delta sales to our own Gamma console; but, Delta will be the market in future.”*
- *“After we out-compete Entco, other firms eyeing the market will think twice as they will have to get our gamers and game designers to move across to their untried offering.”*
- *“Advertising is a major expense with any consumer electronics device – both as it is introduced and to maintain interest in games/add-ons. An entrant without a ready untapped market cannot afford to play around on the edges.”*