

The Microsoft / Yahoo! Search Business case

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1. Introduction

On 18 February 2010 the Commission cleared the acquisition of the Yahoo Search Business by Microsoft ⁽²⁾. This was the first case of a concentration between two major search engines and one which raised a number of interesting issues.

The first challenge concerning the transaction was to determine whether it fell within the scope of Council Regulation (EC) No 139/2004 ('the Merger Regulation') ⁽³⁾. The structure of the operation was complex and it included a number of cooperative features that made it a case between a concentration and a commercial agreement.

This case was also noteworthy for the fact that the Commission had to analyse the functioning and the economics of the complex and dynamic market of online search, which is a relatively new market characterised by the presence of two-sided platforms that provide on one hand, free internet search to users and, on the other hand, remunerate search advertising to advertisers. In its competitive assessment, the Commission had to consider and weigh up two aspects of the transaction. On the one hand, the two companies involved had a small combined market share which was significantly lower than that of their main competitor, Google, and historically these companies had encountered serious difficulties in competing effectively against Google as separate entities. On the other hand, the concentration was a merger from three to two between the second and third players, in a market where barriers to entry appeared to be high. For these reasons, the Commission conducted a relatively extensive first phase market investigation.

This article describes in details the Commission's assessment of this concentration. Another article published in this issue of the Competition Policy Newsletter offers an economic background for the analysis conducted by the Commission which can be read as a useful complement of the present article ⁽⁴⁾.

⁽¹⁾ The content of this article does not necessarily reflect the official position of the European Commission. Responsibility for the information and views expressed lies entirely with the authors.

⁽²⁾ http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=2_M_5727.

⁽³⁾ OJ L 24, 29-1-2004, p. 1.

⁽⁴⁾ Economic background of the Microsoft/Yahoo case by Andrea Amelio and Dimitrios Magos.

2. The parties and the transaction

Microsoft Corporation ('Microsoft') is involved in the design, development and supply of computer software and the supply of related services worldwide. The transaction concerned its Online Services Business segment and, more specifically, Microsoft's on-line search platform, Bing, and its online advertising platform, adCenter.

Yahoo is a global internet consumer brand and one of the most trafficked internet destinations worldwide. The transaction concerned Yahoo's web-wide algorithmic search and search advertising business, including Yahoo's search advertising platform, Panama (the 'Yahoo Search Business').

The transaction whereby Microsoft and Yahoo combined their online web-wide algorithmic search and search advertising businesses had a complex structure. The parties entered into a Licence Agreement and a binding Search and Advertising Services and Sales Agreement (the 'Agreements') which provided for the transfer to Microsoft of the Yahoo Search Business through the transfer of relevant assets (technology and customers relations) and also employees.

More particularly, the Agreements provided that Microsoft would acquire a ten-year exclusive licence to Yahoo's core search technologies, that Yahoo would exclusively use Microsoft's search engine on Yahoo sites. Microsoft would therefore become the exclusive search advertising provider used by Yahoo. While Yahoo would continue to independently determine the content and user interface of its sites, Yahoo's advertising platform, Panama, would be discontinued and Yahoo's customers would be migrated to Microsoft's adCenter. Finally, Microsoft agreed to hire not less than 400 employees from Yahoo.

A peculiar aspect of the Agreements was the fact that, under the Agreements, Yahoo would become the exclusive worldwide relationship sales force for the services provided by adCenter to so-called Premium Direct Advertisers ('PDAs') ⁽⁵⁾.

⁽⁵⁾ PDAs purchase advertising space through Microsoft's and Yahoo's advertising platforms, but in addition have a contract with Microsoft or Yahoo's sales force in which additional services such as keyword optimisation and rebates may be agreed. They oppose to self-served customers, which purchase advertising space on Microsoft's and Yahoo's search pages online via adCenter and/or Panama, without interaction from a sales force.

The coexistence of cooperative and concentrative features in the transaction raised the question of whether it amounted to a concentration. The Commission analysed each element of the transaction in line with the criteria laid down by the Merger Regulation and in the Consolidated Jurisdictional Notice ('CJN')⁽⁶⁾. In particular, the Commission addressed the following questions: (i) whether the technology, the customer relations and the employees of the Yahoo Search Business which would be transferred to Microsoft constitute a business to which turnover could be attributed, (ii) whether a ten-year licence agreement with early termination clauses and the transfer of customers and employees could be considered as a way of bringing about a change of control on a lasting basis, (iii) whether the entity would indeed be solely controlled by Microsoft or whether Yahoo's control over the customer relationship with PDAs would involve Yahoo retaining joint control over at least some parts of the new business.

2.1. Object of control: the assets and employees of the Yahoo! Search Business transferred to Microsoft constitute a business to which turnover can be attributed

According to the Merger Regulation and the CJN, the acquisition of control over assets can be deemed to be a concentration, if those assets constitute the whole or a part of an undertaking, i.e. a business with a market presence to which a turnover can be clearly attributed. The underlying idea is that the transferred assets must allow the purchaser to at least develop a market presence. In particular, according to the Commission's practice, a concentration can be based on a combination of assets containing the necessary elements for a business (such as production facilities, goodwill and market access)⁽⁷⁾.

The Commission assessed all aspects of the transaction, including those that could militate against the findings that the assets involved could constitute a business, such as the fact that not all the technology licensed to Microsoft was licensed on an exclusive basis. With regard to this aspect, the Commission found that the granting to Microsoft of an exclusive, ten-year term licence for non-patent IP rights (such as copyright as regards software code) seemed to be sufficient to prevent both Yahoo and any other actors from using Yahoo's core search technology in competition with Microsoft.

⁽⁶⁾ OJ C 95, 16-04-2008 p. 1.

⁽⁷⁾ See, for example, Cases M.3583 *Flextronics/Nortel* at paragraph 4, M.3410 *Total/Gaz de France* at paragraphs 6 to 8, M.890 *Blokkers/Toys'R'Us* at paragraphs 6 to 11 and M.286 *Zurich/MMI* at paragraph 5.

On this basis, and taking into account that (i) search and advertising platform technology, (ii) human capital and (iii) advertising customers are the three most essential elements for a search advertising business, the Commission concluded that the assets transferred were a business with a market presence to which a turnover could be attributed.

2.2. Lasting basis: the transaction brings about a change of control on a lasting basis

In assessing whether the transaction was capable of bringing about a change of control on a lasting basis, the Commission took into consideration the fact that the industry involved is characterized by rapid, continuous developments in technology, and constant innovation. Consequently, a period of ten-years – a duration which is also in line with the CJN⁽⁸⁾ – was seen as a particularly long period in the field of internet search.

The Commission also assessed the early termination provisions in the agreement and concluded that none of the events taken into account were sufficiently likely and close in time as to deprive the transaction of its long-lasting character. Moreover, the Commission considered that, even if the transaction was terminated early, there was no provision of forced return for the employees and the customers transferred to Microsoft. Similarly, the technology licence would remain in effect and become non-exclusive, which would still allow Microsoft to exploit it.

On this basis, the Commission considered that the acquisition of control occurred on a lasting basis because the transfer of technology assets, employees and customers was to be regarded as irreversible.

2.3. Sole control: the entity is solely controlled by Microsoft

As the Agreements did not create a joint venture in which the parties shared the voting rights equally, the Commission considered whether joint control could arise out of veto rights (or similar means) or out of a commonality of interests.

In particular, the Commission assessed whether the fact that Yahoo would become the exclusive sales force of the new business for PDAs would mean that Yahoo would retain control over this part of the business. However, in the light of the industry-wide practice of rebates, Yahoo's potential ability to decide on the commercial strategy in relation to PDAs was not considered sufficient to be regarded as a strategic decision conferring, per se, control

⁽⁸⁾ Paragraph 28 and footnote 34.

over a business. Moreover, the Commission considered that Yahoo was not offering a ‘vital contribution’ to the business other than internet traffic and sales services and that therefore there was not a sufficiently ‘high degree of mutual dependency’ between Yahoo and Microsoft to reach the ‘strategic objectives’ of a JV^(?) beyond the common interest inherent in any long-term commercial agreement.

On the basis of the above, the Commission concluded that the transaction constituted an acquisition of sole control by Microsoft over a part of an undertaking (the Yahoo! Search Business).

3. The industry and the characteristics of the markets

The transaction concerned the markets for internet search and online advertising which are relatively new, complex and characterized by innovation. Both markets are served by search engines that operate two-sided platforms connecting users and advertisers.

3.1. Internet search users

On the user side, an internet search engine, like www.bing.com, www.google.com and www.search.

yahoo.com, is a tool designed to search for information on the internet. Search boxes in which queries can be typed have become a widespread and familiar tool to most internet users. Search engines use algorithms to find relevant search results that are then displayed in a ranked list of links that can also include maps, videos, images etc. The results of a user’s query are known as natural algorithmic search or organic results.

Users can perform different types of searches. Searches that are performed on one of the above search engines are general internet searches and their results are based on software that searches the content of the whole World Wide Web (so-called ‘web crawlers’). However, searches could also be performed on specific search engines that focus on specific topics (such as legal, medical or travel issues) and carry out their search only on a segment of the web that is relevant to the pre-defined topic/s. These searches are vertical internet searches. Finally, searches could be limited only to the content of a specific webpage (‘site searches’), such as newspaper or social websites like Facebook. The following chart illustrates the different searches that a user can perform.



(?) Paragraph 77 of the CJN.

3.2. Advertisers

While internet search results are usually provided free of charge to users, search engines are financed by advertising revenue that is generated by selling space ('inventory') on their search results pages to advertisers, where search advertisements ('sponsored links') can be displayed. This means that, in practice, users conducting a search receive on a results page both organic search results and sponsored links consisting of advertisements related to the query and provided by the internet search engine.

Advertisers buy search advertising space for those sponsored links on the basis of keywords included in search queries of users. Keywords are 'auctioned off' to advertisers through advertising platforms that allocate a ranking to an ad based on how much advertisers bid per click for a given keyword query and how many clicks the platform expects each ad to generate ('ad relevance'). The auction mechanism is further explained in the article 'Economic background of the Microsoft/Yahoo case' published in this issue of the CPN. An important feature of this system is that advertisers only pay when the user clicks on the hyperlinked search directing the user to a web page determined by the advertiser ('landing page').

3.3. Interdependence between the two sides of the platform

Demands from users and advertisers are interdependent. Users value the relevance of the internet search, including both organic and advertising results. Advertisers aim to reach a large audience and monetize their investment in advertising. In both cases, what matters is the amount of search traffic

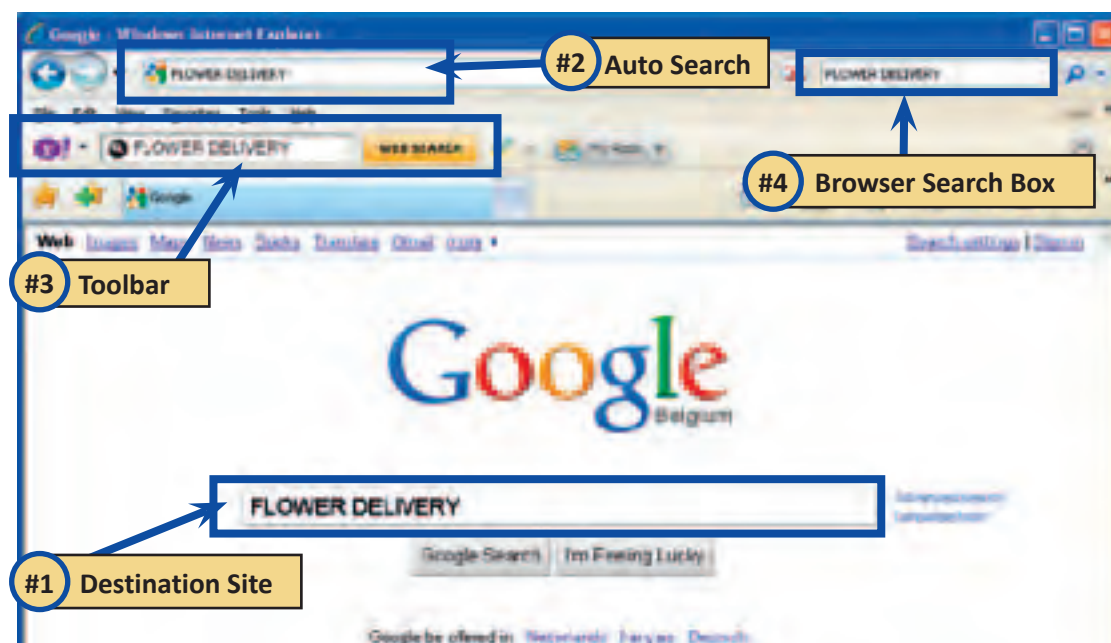
that is conveyed to one search engine, as significant search traffic will, on the one hand, increase the search engines' ability to provide relevant search results to users and, on the other hand, attract a larger number of advertisers.

The Commission analysed data concerning users' habits and profiles and the distribution of advertisers among the main search platforms. Although the Commission's analysis was not conclusive in terms of the users' profiles, it did confirm that users tend to 'single-home', meaning that they perform over 90% of their search queries within a month on one single search engine. Unlike users, most advertisers who responded to the market investigation indicated that they 'multi-home' on all three ad platforms, meaning that they advertise on adCenter, Panama and adWords, in order to reach the largest possible audience.

In order to increase search traffic, search engines try to attract users by multiplying the ways in which users can access their internet search services. Users can access internet search services not only through the search engine home page (destination page) but also through other 'entry points'.

3.4. Distribution channels

Search engines can use so-called 'distribution agreements' with hardware manufacturers, Independent Software Vendors, and Internet Service Providers to distribute automatic search in the address field, toolbars and search boxes on the internet browser and establish default settings that direct user searches to the search engine. These types of entry points, when used, cause the user to land on the search engine's website itself. The following chart provides an overview of possible entry points.



Users can also access search services indirectly on third party websites which have concluded syndication agreements with a search engine. Syndication enables publishers, such as online newspapers, to use search technology on their websites and it allows users to carry out searches directly on the site of the publisher. The searches can be limited to the site or include the whole web. For example, syndication agreements can be concluded with newspaper web-pages: web-readers of newspaper can perform searches on the web-site of the newspaper using the technology of the search engine and its ad platform that will provide the search results and the ads next to the search results. The publishers will be paid a percentage of the advertising revenues (known as a traffic acquisition cost, "TAC").

4. Market definition

4.1. Online advertising

Search advertising is one kind of online advertising. As in previous cases⁽¹⁰⁾, the market investigation confirmed that online advertising is a separate market from offline advertising. The Commission also assessed whether the market for online advertising could be further subdivided according to the selection mechanism (search or non search, or behaviourally targeted ads), the appearance or format (text, video, display), the user device (mobile, laptop) and the pricing mechanism (cost per click, cost per thousand impressions).

In line with the previous market definitions as provided in the Google/DoubleClick case, the market investigation indicated that search advertising could possibly be considered as a separate market, in particular because search advertising ensures direct targeting in response to the search user's expressed intent, whereas other methods, such as display ads, aim primarily at increasing or creating brand awareness.

The market investigation also provided indications that mobile advertising might be considered as a separate market in light of its distinguishing features both technically (for example, the size of the ads) and commercially (for example, the possibility to advertise outlets near to the actual location of the holder of the smartphone). According to some respondents, mobile advertising represents one of the most important recent developments in online advertising.

In the end, the Commission left the exact market definition open, as the merger did not raise serious doubts in the EEA under any alternative market definition.

⁽¹⁰⁾ COMP/M.4731 *Google/DoubleClick*

Geographically, in line with the Google/DoubleClick case, the Commission found that the market for online advertising should be defined based on linguistic borders within the EEA.

4.2. Internet search

For the first time, the Commission considered whether online search constitutes a relevant market, and assessed all relevant elements militating for or against a separate market for online search.

On the one hand, it could be argued that online search does not constitute a relevant market since the services (the search results) are provided free of charge to the users, and therefore a monopolist would be unable to control prices. For instance, in the two-sided market for free-to-air TV, the Commission considered only the market for advertising to be a relevant market, whereas it did not consider the 'free' TV side to be a market.

On the other hand, competition for users is fierce and the quality of internet search strongly influences the success of a search engine. It is also worth noting that other free products, such as internet browsers and open source software, have been considered as competitors on their respective markets. Finally, in State Aid cases, the Commission has scrutinised the public financing of public service broadcasters, even if those services (and the services of competing free-to-air broadcasters) are provided free of charge.

Ultimately, the Commission left the product market definition open.

As regards the geographic scope of internet search, while the largest search engines operate on global basis, many users require a search engine and search results in their own language. Ultimately, the Commission left the geographic market definition open.

4.3. Other markets

The Commission also considered a possible market for intermediation in online advertising, where both parties are active, and whether there was a separate market for distribution agreements on entry points to search engines. As the proposed transaction raised no serious doubts in either case, the market definition was again left open.

5. Competitive situation in the relevant markets

In its competitive assessment, the Commission carefully assessed all the various elements of this transaction, and in particular the fact that this operation would have resulted in a concentration from three to two players in a market where barriers to entry

appeared to be high⁽¹¹⁾. At the same time, the Commission was also conscious of the limited combined market shares held by Yahoo and Microsoft in the EEA, which were below 10% in both search and search advertising. Nonetheless, the Commission decided to conduct a relatively extensive first phase market investigation due to the complexity of this relatively new industry, the high entry barriers and the fact that competition in these markets takes place in terms of quality and innovation. The Commission's analysis covered two aspects. Firstly, the Commission assessed the relevant counterfactual, namely the expected market evolution if there were no merger, and the overall effects of the transaction against such a background. Secondly, due to the multi-sided nature of these markets, the Commission assessed the impact of the transaction for each relevant group of players, namely advertisers, users, publishers and distributors. In its analysis the Commission also took into account the almost unanimously positive replies to the market survey, where respondents not only did not raise any competition concerns, but actually indicated that the transaction would have had pro-competition effects. Finally, the Commission also considered the possible beneficial effects for the consumers.

5.1. The relevant counterfactual

As regards search advertising within the EEA, Microsoft and Yahoo only competed in France and in the UK and the information provided to the Commission indicated that they both held very small market shares. Moreover, Microsoft's internal documents indicated that Microsoft had no intention of expanding its adCenter advertising platform in other EEA Member States in the foreseeable future. Therefore the Commission considered that the elimination of potential competition in the rest of the EEA was limited.

The information and the data collected by the Commission also consistently indicated that both Yahoo and Microsoft were experiencing serious difficulties in competing effectively with Google, which enjoyed market shares mostly in excess of 90% and had recently gained further market share, mainly at the expense of Yahoo. According to the parties' submissions, these difficulties were mainly due to a lack of scale. Indeed, a search business requires substantial and continuous investments in the quality of search and related R&D, and it is subject to network effects in that scale can improve the quality of the search results and the quality of the matching of the ads with the queries. The market investiga-

tion confirmed that scale is an important aspect in the economics of the industry.

At the time of the notification, the competitiveness of Yahoo had been declining gradually but significantly for some years within the EEA and it did not appear to have the financial strength to reverse this trend. The market investigation confirmed that the performance of Yahoo's search engine was decreasing and that Yahoo was no longer considered an important innovator in search advertising. The Commission took the view that these difficulties were likely to continue absent the merger and that Yahoo was unlikely to become an effective competitor.

Microsoft also faced difficulties in becoming a credible alternative provider to Google. Despite very significant investments in its internet search and search advertising business, Microsoft's organic growth was limited and its scale and market shares remained modest and, financially, loss-making. According to Microsoft, it was the lack of scale that hampered its ability to innovate effectively and compete. During the market investigation, advertisers almost unanimously made the point that Microsoft did not have enough traffic to compete effectively with Google.

Finally, the Commission assessed Microsoft's and Yahoo's position against that of Google, who was the undisputed market leader in search advertising in the EEA and worldwide. The market investigation confirmed that Google's search traffic made it a 'must have' for search advertising campaigns and the data provided to the Commission indicated that the vast majority of users 'single-homed' on Google.

5.2. Detailed assessment of the different players

The Commission assessed in detail the potential effects of the proposed transaction on the various market players, namely advertisers, users, distributors and publishers.

As regards advertisers, the Commission investigated whether the combination of adCenter and Panama into a single search advertising platform could have led to an increase in the auction price and in the minimum bids. The Commission's theory of harm was based on two elements (i) the elimination of Panama as a competitive constraint and (ii) the increase in the bidder density for a particular keyword due to the pooling of advertisers on adCenter⁽¹²⁾.

⁽¹¹⁾ Barriers to entry to this market include among others, hardware, cost of indexing the web, human capital, cost of developing and updating the algorithm and IP patents.

⁽¹²⁾ See article 'Auction design and the interdependence between organic and sponsored links in the Microsoft/Yahoo case: an economic view' by Andrea Amelio and Dimitrios Magos.

The market investigation indicated that an increase in the auction price would have been unlikely and, even if it had taken place, its effects would have been limited. Firstly, with regard to the elimination of Panama's constraint, any such constraint was limited to France and the United Kingdom - the only two Member States where Microsoft and Yahoo were competing pre-merger. Secondly, with regard to the possible increase in the bidder density, many of the respondent advertisers were already conducting search advertising campaigns on all three platforms in parallel. Therefore, the potential number of additional advertisers bidding for the same keywords on adCenter was limited to those that were previously present only on Panama and not on adCenter. Finally, the market investigation indicated that while the cost per click is an important consideration for an advertiser, advertisers' decisions are mainly driven by their return on investment on a platform and that they are willing to pay a higher cost per click if the relevance of the ad displayed is higher, as it then leads to a higher return on investment. On this point, the majority of the advertisers said that they expected the transaction to allow Microsoft to compete more effectively against Google.

As regards search users, the Commission's main question was whether, post-merger, with the elimination of an algorithmic search engine, the combined platform might diminish the relevance of the organic search results⁽¹³⁾. The Commission also investigated whether there would have been a lower incentive to innovate and whether users would have been harmed by the loss of variety of the differentiated services offered by different platforms.

The market investigation confirmed that the quality and relevance of the algorithmic search engine is the most important factor in attracting users to a particular search engine. However, the Commission considered that a very limited proportion of users multi-homed between Microsoft and Yahoo, and thus users rarely ran checks between these two platforms. Moreover, given the structure of the transaction, the publishing businesses of Microsoft and Yahoo would have remained separate post-merger and Yahoo would still have offered its independent complementary services. The Commission

therefore considered that Yahoo would still have an incentive to compete for users and thereby innovate on the overall users' experience post-transaction.

As regards online publishers and distributors, the Commission investigated whether the removal of one advertisement platform and independent search engine would have limited publishers' opportunities to monetize their web pages and lowered the remuneration of distribution deals.

The market investigation indicated that, with regard to these agreements, the parties either competed to a very limited extent or not at all. Moreover, according to the agreement, Yahoo would have continued to compete for distribution and syndication deals post-merger. Finally, the respondents to the market investigation indicated that they expected the transaction to increase the parties' ability to compete with Google in this sector.

With regard to distribution agreements, the Commission also investigated whether, in a conglomerate context, the proposed transaction would have increased Microsoft's ability to leverage its market power in areas other than online advertising (for example, PC operating systems and personal productivity applications) when negotiating distribution agreements for its search technology (for example by bundling products). On the basis of the result of the market investigation, which did not reveal any merger-specific conglomerate effects, the Commission concluded that the Agreements did not contain anything to suggest that the transaction would have increased Microsoft's ability and/or incentive to leverage its strong market position in non-search areas.

5.3. Possible beneficial effects

In its analysis, the Commission also considered Microsoft's arguments that the transaction would have had positive effects. According to Microsoft, the rationale of the transaction was the acquisition of Yahoo's scale, which would enable Microsoft to become an effective competitor to Google and thus provide greater value to both users and advertisers. On the one hand, increased traffic volumes would make more experiments possible, leading to improved search results, especially for less frequent queries. On the other hand a higher degree of user engagement would have a positive effect on advertisers' return on investment.

Overall, the market investigation confirmed that scale is an important factor in order to be an effective competitor in this sector. The market investigation further confirmed that the proposed transaction was perceived as having pro-competition effects, as it would have created a stronger competitor to Google. The Commission did not adopt a final position on this point, as its assessment was

⁽¹³⁾ Theoretically, the rationale for possibly degrading the organic search stems from the trade off that search platforms appear to face between the incentive to provide relevant organic and paid results. The trade off arises because when a platform tries to attract more users through greater relevance on the organic search it runs the risk of losing revenues on the advertising side (i.e. less clicks on ads) due to users clicking predominantly on the organic side (especially if both types of clicks would bring the user to the same kind of information) (see article 'Economic background of the Microsoft/Yahoo case' by Andrea Amelio and Dimitrios Magos).

based mainly on the counterfactual and the elements described above.

6. Cooperation with the US authorities

This case was also interesting because it was assessed both in the United States of America and in Europe. The transaction was filed with the US Department of Justice (DoJ) in August 2009 and was the subject of a Second Request. While each authority carried out its independent assessment, they cooperated closely and extensively throughout both the pre-notification phase and the investigation of the case, and ultimately reached similar conclusions on the same date.

7. Conclusion

On the basis of its investigation, the Commission concluded that this three to two merger would be unlikely to have harmful effects on competition,

particularly in the light of the serious difficulties that both Yahoo and Microsoft were facing in competing with Google and of the limited market shares that the two parties held in the EEA. The Commission thus cleared the transaction on 18 February 2010.

This case represents an important step towards a better understanding of the complex industry for online searches and search advertising – an industry characterised by the presence of two-sided platforms providing, at one and the same time, free internet search to users and remunerated search advertising to advertisers. The investigation conducted by the Commission revealed the high level of interconnection between the different sides of the business and the importance of scale in being able to run regular experiments aimed at improving search and search advertising platforms.