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**MAY 2007**

## Drawing vertical lines

### EUROPEAN GUIDELINES ON NON-HORIZONTAL MERGERS

*In February 2007, the European Commission added the last important piece to its redesign of merger control. The EC had amended the substance of its test for merger review, and published guidelines for the control of horizontal mergers, by the end of 2004. Now draft guidelines have been published for non-horizontal mergers – a welcome step into a difficult area, although the draft still leaves some issues to be addressed. This bulletin discusses ways in which the guidelines could be enhanced, notably by the development of a more explicit framework for the weighing-up of foreclosure concerns against offsetting consumer benefits.*

Non-horizontal mergers are those agreed by companies in vertical (e.g., between manufacturers and distributors) or related (e.g., complementary or neighbouring) markets. Unlike horizontal mergers, they do not automatically lead to a reduction in the number of firms competing in each of these markets, and so there is no direct loss of competition. If there is any increase in market power, this instead



arises from strategic behaviour by the merged company or efficiencies enabled by the merger process.

Because such mergers involve more than one market, analysis of their competitive effects is often complicated. To add to this complication, the efficiencies gained from non-horizontal mergers may be quite different from those arising in horizontal mergers. Non-horizontal mergers may, for example, reduce transaction costs by replacing contractual relationships with more efficient intra-group arrangements. Weighing any threat to competition against potential efficiency gains is a challenging business.

Most non-horizontal mergers raise no competition issues, although some have been found by the Commission to do so. There have been several recent cases (such as Tetra-Laval/Sidel and GE/Honeywell) where the Commission's decisions to prohibit non-horizontal mergers have exposed it to criticism of its approach by the Court of First Instance. One of the aims of the draft guidelines must surely be to reduce the Commission's exposure to appeal by placing its analysis of non-horizontal mergers on a more secure theoretical footing.

### FRAMING THE PROBLEM

The draft guidelines go a long way to identifying the appropriate context for the analysis of non-horizontal mergers, by acknowledging plainly that:

- non-horizontal mergers “are generally less likely to create competition concerns than horizontal mergers”;
- the mere fact that a merged company has a broad range of products does not in itself raise concerns;
- non-horizontal mergers “provide substantial scope for efficiencies”;
- strategic conduct post-merger, such as tying or bundling, may be efficient in many cases; and
- the ultimate concern in non-horizontal mergers is harm to consumers, whether intermediate or final.

The guidelines also lay down the presumption that non-horizontal mergers pose no threat unless the merged entity has market power. They indicate that the Commission is unlikely to take action if the merged company's share in each of the markets concerned is below 30%, and the post-merger Hirschmann-Herfindahl index (the HHI, a commonly-used concentration measure) is below 2,000.

### TESTING, TESTING

In its discussion of potential threats to competition, the Commission distinguishes between “co-ordinated effects” (a reduction in competitive rivalry from actions taken by the merged company with its rivals) and “unilateral effects” (a reduction in competitive rivalry from foreclosure actions taken by the merged company against its rivals). The principles to be applied to co-ordinated

effects are reasonably clear: they are the same as for horizontal mergers (and in any case have been relied on by the Commission in very few non-horizontal merger cases). The discussion of foreclosure is therefore more interesting, and in this bulletin we highlight the key features relating to vertical foreclosure.

The draft guidelines distinguish between two kinds of vertical foreclosure, which are illustrated in the table below. As an example, the table shows an industry which has four upstream firms (A-D) and four downstream firms (E-H). A and E plan to merge to become AE. The two possible competitive problems are input foreclosure, where AE refuses to sell A's products to E's rivals, and customer foreclosure, where E refuses to purchase from B, C, or D in the upstream market.

Market	Merging parties	Competitors	Type of foreclosure
Upstream	A	B, C, D	Input: AE denies inputs from A to F, G, H
<i>Inputs to:</i>	<i>Merges with:</i>		<i>Or:</i>
Downstream	E	F, G, H	Customer: AE denies B, C, D access to E

The foreclosure matrix in vertical mergers

Source: Frontier Economics

Both types of vertical foreclosure are demonstrations of the same point: that limiting rivals' access to inputs or customers can increase the costs of those rivals and, therefore, may lead to price increases to consumers. However, such actions will be costly to the merged firm, and so it will not necessarily be profitable for the merged firm to take them. Hence the draft guidelines correctly set out a test, for each type of vertical foreclosure, based on the answers to three questions:

○ **Would the merged entity (AE) have the ability to foreclose access to inputs/customers?**

For input foreclosure to meet this first part of the test, AE must have sufficient market power upstream to affect the price of inputs used by downstream producers F, G and H. For customer foreclosure to be an issue, loss of sales to E must be sufficiently serious for B, C and D to deprive them of economies of scale or scope and so drive up prices.

○ **Would AE have the incentive to foreclose access to inputs/customers?**

For input foreclosure to be worth AE's while, it must gain sufficient profitable business from F, G and H in the downstream market (as a result of depriving them of inputs) to offset the loss of profit on sales of inputs to F, G and H. For customer foreclosure to be worth AE's while, it must gain sufficiently from extra upstream business (as a result of depriving B, C and D of sales) to offset the extra costs of using only in-house supply. Crucial factors in the determination of incentive are the extent to which input/customer foreclosure leads to a sales loss for the upstream/downstream business respectively, the impact this loss has on rivals' costs and so prices, the proportion of customers switching to the

downstream/upstream arms (respectively) of the merged firm, and the margins the merged firm makes on upstream and downstream sales.

In many cases, even a dominant upstream player is unlikely to have an incentive to foreclose access: if, for example, the downstream market is larger and more profitable; if F, G and H are much bigger than E; or if B, C and D are more efficient producers than A.

○ **Would foreclosure by AE be a “significant impediment” to competition in the downstream market?**

The guidelines suggest that this part of the test requires, as a minimum, that a sufficiently large number of rivals would be adversely affected by AE’s conduct to allow AE to raise prices. To meet this condition, the guidelines require that “a significantly large fraction of ... output” must be affected, or the barriers to entry must be raised. One possibility for the latter might be if new entrants, post-merger, needed to enter both the upstream and downstream markets to protect themselves against the threat of foreclosure – so raising the costs of entry.

A similar three-part test applies to conglomerate mergers – those that are neither horizontal (involving firms operating in the same market) nor vertical (involving firms operating upstream and downstream of each other), but instead involve firms operating in closely related or neighbouring markets. Such mergers often involve firms selling two products that are both necessary inputs for a particular end-product. Here too the draft guidelines distinguish between “co-ordinated effects” and “unilateral foreclosure”.

The analysis in this part of the draft guidelines is very much an echo of the approach to vertical mergers. Again, the key concern is whether the merged firm would have not only the ability, but also the incentive, to leverage its position (in this case into a related or neighbouring market) by such practices as “tying” or “bundling”.

Tying or bundling may, of course, be motivated by efficiencies, but the draft guidelines add the warning that in some circumstances they may reduce rivals’ ability to compete to such an extent that the merged firm is able to raise prices. The draft guidelines again set out a three-part test of the ability to foreclose, the incentive to do so and the effect on competition of any such foreclosure.

#### FILLING IN THE GAPS

The draft guidelines are broadly to be welcomed. However, it would be helpful if the Commission could rebalance some of the emphasis and fill in some gaps prior to final publication. In particular, the Commission could more helpfully have set out a framework within which the two underlying sources of economic issues – namely the so-called “efficiency offence”, and strategic foreclosure – can be analysed.

To begin with the “efficiency offence”: if the merger leads to the merged firm becoming more efficient than its competitors in terms of marginal cost, it will have an incentive to cut prices. This behaviour is, in competition terms, “non-

strategic” – price reductions following efficiencies are consistent with the normal business objective of maximising profits, irrespective of whether the effect is to foreclose rivals. However, higher cost rivals will lose sales – and may exit the market if this sales loss is sufficiently large, or may cease to innovate and expand into new areas. If the extent of exit (or cut-backs in expansion plans) allows the merged firm subsequently to raise prices, then consumers may be adversely affected.

For this to happen a sufficient number of rivals (or their expansion plans) must be both:

- marginally profitable; and
- unable to replicate the merged firm’s efficiency through counter-merger or similar contractual relationships short of merger.

Moreover, there must be barriers to re-entry preventing firms that have exited from returning in response to any attempt by the merged firm to raise prices. And, even in this case, it should not be forgotten that any competitive problems would have arisen from the merged firm becoming more efficient than its rivals – and greater efficiency is not usually a concern of competition law.

Nonetheless, it was this argument that, at least in part, appeared to form the basis of the Commission’s case for prohibiting the GE/Honeywell merger – which led to considerable controversy. The draft guidelines’ silence on the nature and relevance of the argument is, therefore, somewhat surprising.

By contrast, the guidelines do focus on strategic behaviour. The main example explored within them is where a merging firm leverages its “strong” market position into the market where it is “weak”. The mechanics are broadly the same as in the efficiency offence – lower prices are charged in one market, so that rivals lose sales, which may lead to exit or reduced expansion plans, and so to higher prices in the long run. The crucial difference is in the motivation. With pure strategic foreclosure – “strategic” behaviour – there is no efficiency justification for the lower prices. Price reductions can only be profitable if the foreclosure leads to higher future prices.

It would be useful if the guidelines could spell out whether the Commission considers the efficiency offence to be a potential problem to be investigated when considering non-horizontal mergers, or whether this is off the agenda. By failing to make this clear, the guidelines could be taken as allowing both strategic and non-strategic behaviour to be problematic.

A further area in which expansion would be useful is in relation to the proposed safe harbour thresholds. At first glance, the Commission’s indication of the concentration level at which the risk of competitive harm may arise seems over-cautious. On concentration levels, as noted above, the draft guidelines state that:

...the Commission is unlikely to find concern in non-horizontal mergers...where the market share of the new entity in **each** of the markets concerned is below [30%] and where the post-merger HHI is below [2,000].  
[*Emphasis added*]

In other words, a non-horizontal merger is outside the “safe harbour” in which the parties can be reasonably confident that their merger would not be blocked if the market share of the two entities is above 30% in the “strong” (higher-share) market – irrespective of their share in the “weak” (lower-share) market.

However, various scenarios that were outside this “safe harbour” would still be unlikely to raise concerns. Suppose that the market share of the merged firm in the weak market were only 1%, and that this were the downstream market. To have an incentive to engage in foreclosure post-merger, the upstream firm would need to raise input prices to its downstream rivals, to shift sales and share to its own downstream arm. But if the share of its downstream arm were only 1% at the merger, it would be unlikely to have great capacity to deal with a significant increase in sales. Downstream rivals would not, therefore, be greatly affected, and so foreclosure does not appear particularly plausible.

It makes sense for the Commission to be cautious in defining the “safe harbour”, and finding the right boundaries is not an easy task. But at present the proposed approach runs the risk of subjecting to scrutiny many mergers that are extremely unlikely to raise competition concerns.

#### COMPETITORS OUT OF THE RING

The draft guidelines do usefully make it clear that consumer harm can only begin to occur where there is demonstrable foreclosure of rivals, and that even then harm is not a forgone conclusion. However, the guidelines lack precision on the exact test to be applied for foreclosure: that is to say, how it should be measured. A distinction could be made between “weak” foreclosure (a reduction in rivals’ ability to compete through a relative inefficiency, but without resulting in exit or reduced long-term incentives to expand) and “strong” foreclosure (resulting in exit or considerably reduced expansion plans). It would be helpful for the Commission to make it clear in the final version of the guidelines what it considers the litmus test of foreclosure to be.

The impact on consumers will be greater where rivals are being forced to exit the market (with no prospects for re-entry) or being marginalized to the point where they have no incentive to ramp up their activities. In assessing the chances that rivals will, in fact, be excluded, it is crucial to understand their cost structures, and in particular the balance between fixed and sunk costs and variable costs for different types of investment.

A rival will, or should, exit immediately (or mothball its plant) if it cannot cover its variable costs, but may remain in the market – at least in the short term – if it can cover these even if it does not make any contribution to its fixed and sunk costs. Exit will only occur where the firm needs to reinvest fixed and sunk costs (such as by engaging in necessary maintenance or upgrading to the latest technology) but does not think that it would make a sufficient return to do so.

Plainly, the greater the impact of foreclosure on rivals’ profits, the greater the chance that rivals will not be able to cover variable costs, and the greater the likelihood of immediate exit. At the same time, if variable costs are low and fixed costs high, rivals may stay in longer: but once they exit, the likelihood of re-entry

is lower. By contrast, firms' expansion plans may be affected immediately, since they normally require the investment of fixed and sunk costs up-front. As with a re-entry, therefore, profits have to be high enough to cover those costs.

### CONSUMERS TO THE FORE

Probably the most important shortcoming of the draft guidelines is that too little attention is devoted to explaining the pro-competitive effects of non-horizontal mergers, and the weight to be attached to them. The Commission's heart may be in the right place, but its truncated treatment of these issues does not send the best signal.

Average prices may well fall as a result of non-horizontal mergers. For example, vertical mergers often squeeze out one element of "double marginalisation", whereby the upstream supplier charges a monopoly price, and the downstream firm takes the input price as given and then adds its own mark-up. An end to double marginalisation may therefore result in both lower prices to final consumers and greater profits for the merged firm. Non-horizontal mergers may also reduce transaction costs – for example, by obviating the need for the complex contracts that may be required between independent firms to align their interests. The Commission could do more to rebalance the guidelines in this direction.

### CONCLUSION

Overall, the draft guidelines set out a coherent economic framework for the analysis of non-horizontal mergers, and the assessment of competitive harm, and are therefore greatly to be welcomed. They are an excellent response to past criticisms of Commission practice with respect to these kinds of mergers.

However, there are still gaps and a need for emphasis to be addressed in the final version. The most important of these are:

- an expansion of the framework to include more guidance on how foreclosure will be defined and assessed;
- a need to give recognition to the possibility that foreclosure concerns may result from efficiencies enabled by the merger and guidance on how such foreclosure effects will be considered;
- a need for more practical guidance on how consumer benefits resulting from efficiencies will be weighed against the probability of foreclosure; and
- a need to make it clear that, since the concentration limits defining the "safe harbour" are set with deliberate caution, there are circumstances above those levels where harm is unlikely – such as where there is a low market share in the second market.

Failure to address these points will dilute the purpose of these guidelines, which is to create greater certainty in the marketplace and reduce the workload of the Commission. Without departing from the outline provided in the draft, the

Commission could provide greater certainty for merging firms by filling in more of the framework.

*This bulletin draws considerably on a paper by Robert O'Donoghue and David Parker, "The final piece of the jigsaw: an analysis of the Draft Commission Guidelines on non-horizontal mergers", published by eSapience Center for Competition Policy, March 2007. The draft guidelines were published by the European Commission in February, 2007.*

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