Assessment of Mergers – Non-Horizontal Effects

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Outline

1. Introduction
2. Vertical mergers
   - Good things
   - Bad things
     • A. input foreclosure
     • B. customer foreclosure
     • C. information and coordination
3. Conglomerate mergers
   • foreclosure concerns of tying/bundling/portfolio effects
1. Introduction

Definitions:

• **Horizontal merger**
  
  - a merger between companies are actual or potential competitors in the same relevant market

• **Vertical merger**
  
  - a merger between companies that have an actual or potential supplier-customer relationship

• **Conglomerate merger:**
  
  - a merger that is neither purely horizontal or purely vertical
Context

• Merger regulation revised 20 January 2004
  – from "creation or strengthening of a dominant position"
  – to "Significant Impediment to Effective Competition"

• Horizontal merger guidelines 5 February 2004

• Court decisions
  – Airtours v Comm. 06.06.02 T-342/99
  – Schneider v Comm. 22.10.02 T-310/01 & T-77/02
  – Tetra Laval v Comm. 25.10.02 T-5/02 & T-80/02
  – EDP v Comm. 21.09.05 T-87/05
  – GE v Comm. 14.12.05 T-210/01

• Non-horizontal guidelines 18 October 2008
  – Report by Professor Jeffrey Church on the impact of vertical and conglomorate mergers
    • http://ec.europa.eu/competition/mergers/studies_reports/merger_impact.pdf

2. Vertical mergers

• Examples of a vertical relationship:
  – producer and retailer
  – car parts producer and car producer
  – cement producer and concrete producer
  – electricity producer and distributor

• Vertical mergers have implications which differ from horizontal mergers: a horizontal merger is a merger between *competitors*, whereas a vertical merger is a merger between players that are *complementary*
Theory of the firm

• What decides the boundaries of a firm?
• To get a final product/service to the final customer requires a number of subproducts and subservices.
  – R&D, Raw materials, Combining the raw materials, Feeding the employees, Cleaning the factory, Distribution, Advertising, Accounting
• Which of these activities should a firm do themselves and which should be left to the market?

Market based transaction

Internal transfer
Vertical mergers

• Advantages of being independent:
  • External pressure from competition keeps each entity “on their toes”
  • Easier to handle smaller entities
  • Better focus on core activities
  • …

• Advantages of being integrated
  • Avoid problems with contracting
  • Internalize externalities
  • Easier to align activities
  • …
A vertically integrated monopolist vs A downstream monopolist

Price

Upstream markup

Marginal downstream cost

Demand

Marginal revenue

Quantity

Downstream monopolist

Integrated monopolist

Upstream markup
Mobile telephony

Domestic on-net call
- Origination
- Termination
- Subscription

Domestic off-net call
- Termination
- Origination
- Subscription

International call
- Origination
- Termination
- Subscription
Aligned incentives

• Vertical merger between gas supplier and electricity producer

  – Gas supplier receives gas in a steady flow
    • but customers mainly need the gas in the winter
    • solution: storage

  – Electricity producer uses gas to produce electricity
    • But they also use other fuels (coal, oil, wood-pellets and straw)
    • Merger potential: use power plants as virtual storage by using gas in the summer and other fuels in the winter.
Good things,… and?

• There are many reasons why vertical mergers may be good for consumers
  • Internal transfers may be better than market based transfers
  • Double mark-ups may be eliminated
  • Incentives may be better aligned

• So what could possibly be wrong with a vertical merger?
Foreclosure!

• Vertical mergers may foreclose competition by
  
  – raising the costs at which competitors can operate on a market (*raising rivals’ cost*); typically associated with *input foreclosure*

  – and/or lowering their expected revenue streams (*reducing rivals’ revenues*); typically associated with *customer foreclosure*

→ may affect the ability or incentive of competitors to compete, and thereby negatively affect consumers
A. Input foreclosure

Before merger: No reason to offer different prices to the two downstream firms

Elimination of double mark-up

Lower downstream prices

But what about also increasing prices to red?

Higher downstream prices
There is only one monopoly profit!

Except if:

- The monopolist is regulated
- Two-level entry is more difficult than one-level entry
- Entry from one level to the other level is easier than entry for a complete outsider
- There is some competition upstream
- …
Input foreclosure may be a concern

• When the merged entity has the **ability** to raise rivals cost;
  – Input must be important
  – Merged entity must have significant market power in the input market

• Has the **incentive** to do so;
  – Downstream profits should be significant
  – Upstream prices should translate into higher downstream prices
  – The rival should be a close competitor

• The **impact** on downstream consumers would be significant
  – The rivals whose cost are raised should constitute an important competitive force
  – The effect on entry barriers should be significant
Gas and electricity merger

Gas supply

Combined Heat and Power

Competing Combined Heat and Power

Heat and power production
B. Customer foreclosure

Input foreclosure

- Market power
- Less competitive pressure
- Raising rivals cost?

Customer foreclosure

- Competitors
- Less competitive pressure
- Restrict access to market?
- Market power
Consumer welfare

- Concept of “consumers”:
  - where intermediate consumers are also competitors of the merged entity, the Commission’s focus will be on customers one level downstream
  - the mere fact that rivals are harmed is not a reason to block a merger
Victims does not equal consumer harm
C. Access to sensitive information

- The merged entity may, by vertically integrating, gain access to commercially sensitive information regarding rivals’ upstream or downstream activities.
  
  - For instance, by becoming the supplier of a downstream competitor, a company may obtain critical information, which allows it to price less aggressively in the downstream market to the detriment of consumers.
Coordinated effects

• **General principle:**
  – Co-ordination more likely to emerge in markets where it is fairly easy to establish the terms of co-ordination and where co-ordination is sustainable
  – Sustainability requires that
    – the companies involved can monitor each other’s market behaviour (market transparency)
    – there is a credible ‘deterrence mechanism’ (disciplining mechanism) to ensure adherence
      – outsiders and customers cannot undermine the co-ordination

• **A vertical merger may have an effect on each of these conditions**
  – reduce the number of effective competitors (due to foreclosure)
    – increase market transparency
    – improve scope of deterrence
    – involve a disruptive buyer
    – raise barriers to entry
3. Conglomerate mergers

- Conglomerate mergers: between firms that are in a relationship which is neither purely horizontal nor vertical.
  - In practice, the focus is on mergers between companies that are active in closely related markets

- Conglomerate mergers in the majority of circumstances will not lead to any competition problems
  - In certain specific cases there may be cause for concern.”
  - Non-coordinated effects or coordinated effects
Non-coordinated effects

• Main concern: foreclosure of rivals by leveraging a strong market position in one market to another, e.g. through
  • Bundling
    – relates to the way products are offered and priced (e.g. pure bundling, mixed bundling)
  • Tying
    – customers that purchase one good (the tying good) are required also to purchase another good from the producer (the tied good). Tying can take place on a technical or contractual basis

• Analytical framework: ability to foreclose – incentive to foreclose – effect on competition (consumers)
(i) Ability to foreclose

- When companies merge and choose to bundle or tie their products, this affects the set of purchase options available to customers in the market
  - demand may shift towards the bundle of the merged company, and away from the products of the single-product rivals

- Necessary conditions for ability to foreclose:
  - merged entity must have market power in at least one of the markets concerned
  - common pool of customers

- Check possible counter-strategies of downstream rivals
(ii) Incentive to foreclose

- Incentive to foreclose depends on the degree to which it is profitable
- Merged entity faces possible trade-off (bundling/tying may come at a cost)
- Incentive may come from the desire to gain market power in tied goods market, protecting market power in the tying goods market, or a combination of the two
- Role of Article 82
(iii) Impact on competition

• Focus: impact on consumers

• Merger may gain market power in tied goods market, protecting market power in the tying goods market, or a combination of the two

• Countervailing factors: Countervailing buyer power, entry, efficiencies
  • Efficiencies (incl. possible internalisation of double mark-ups) to identified by the merging parties; see Section VI