Teleseminar on Non-horizontal merger guidelines
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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

- ”Application of the Nonhorizontal Merger Guidelines” by Raphaël de Coninck, The Antitrust Bulletin vol. 55(4) Winter 2010.

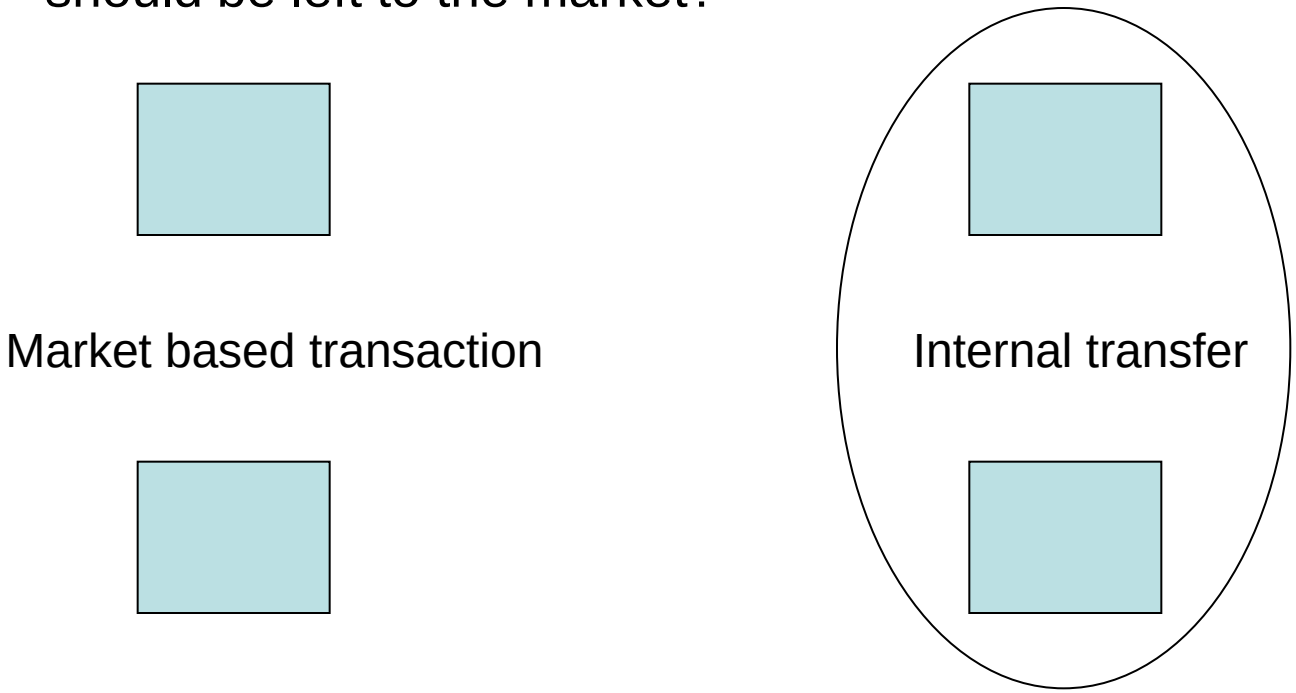
2. Vertical mergers

- 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?

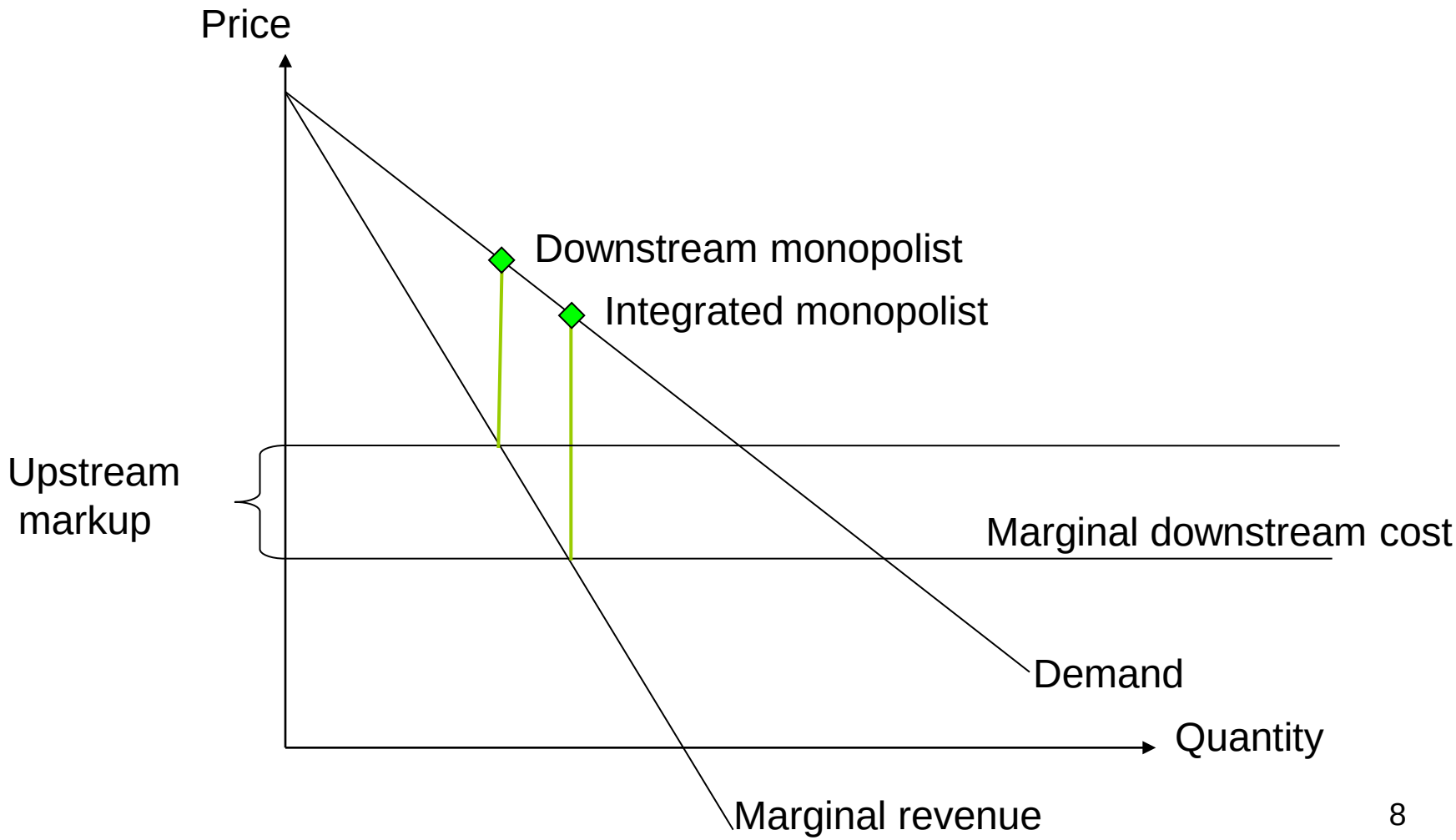


Vertical mergers

- 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 monopolis *vs* A downstream monopolist



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?

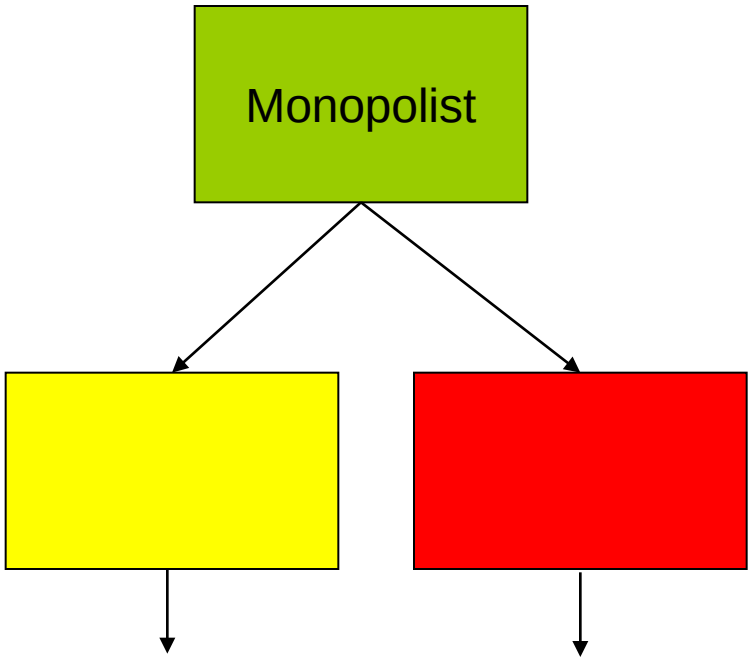
- There are many reasons why vertical mergers may be good for consumers
  - Internal transfers may be better than market based transfers
  - Double mark-ups may be eliminated
  - Incentives may be better aligned
- So what could possibly be wrong with a vertical merger?

Foreclosure !

- Vertical mergers may foreclose competition by
  - raising the costs at which competitors can operate on a market (*raising rivals' cost*); typically associated with <u>input foreclosure</u>
  - and/or lowering their expected revenue streams (*reducing rivals' revenues*); typically associated with <u>customer foreclosure</u>

➔ may affect the ability or incentive of competitors to compete, and thereby negatively affect consumers

A. Input foreclosure



Net effect?

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

Elimination of double mark-up

↓

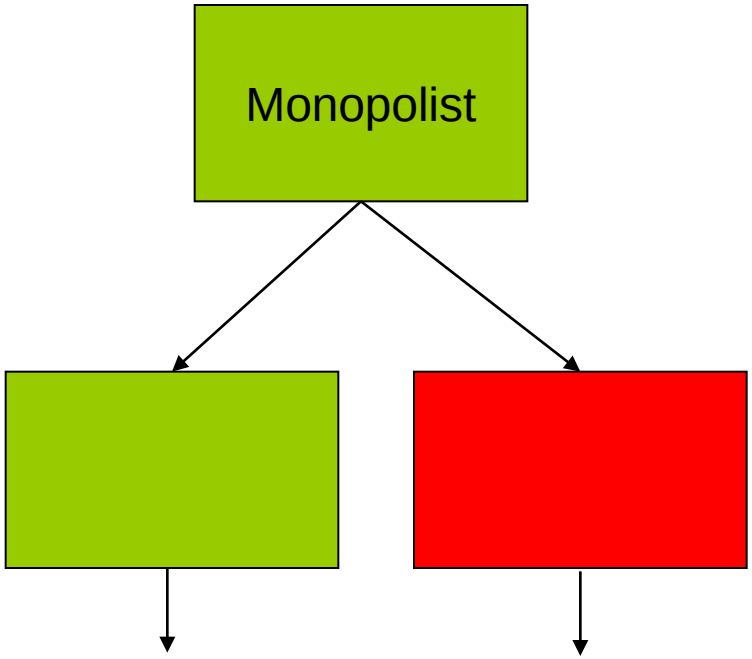
Lower downstream prices

But what about also increasing prices to red?

↓

Higher downstream prices

There is only one monopoly profit!



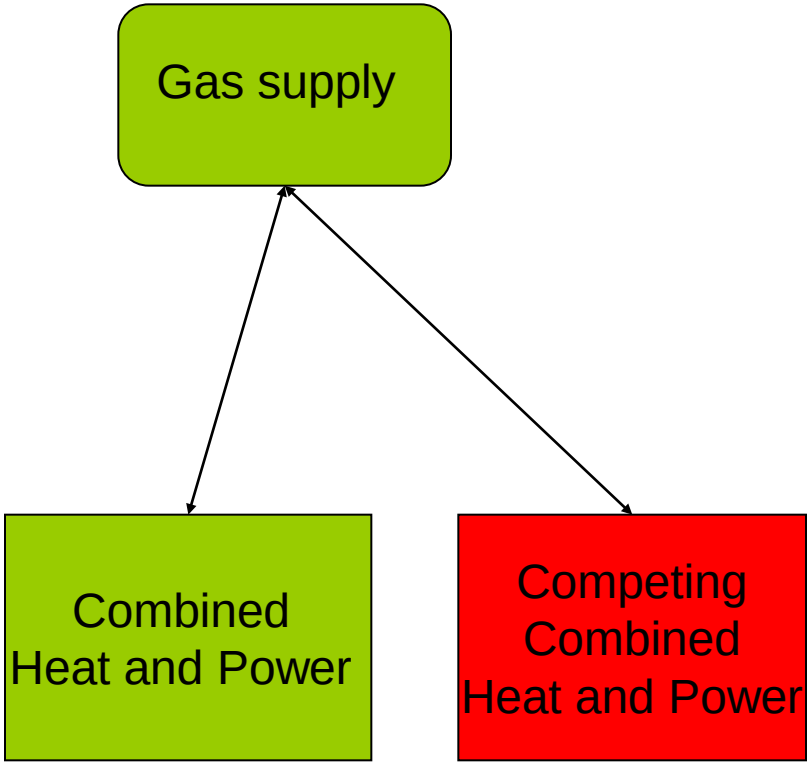
Except if:

- 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

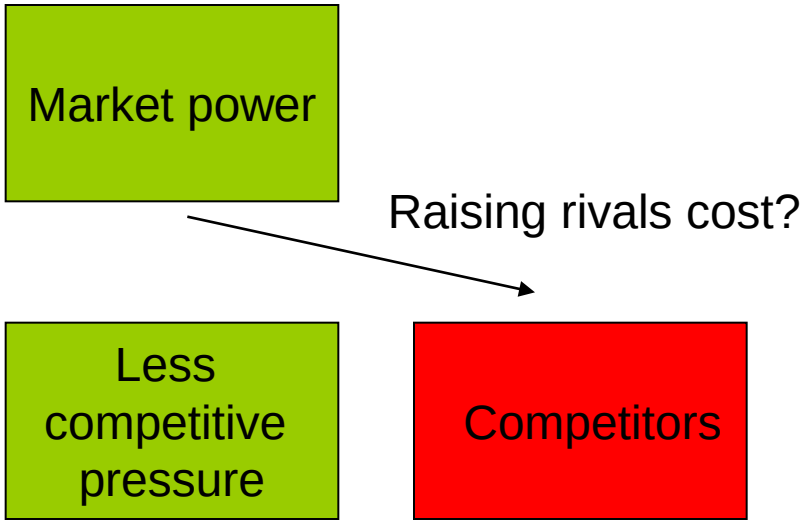
Gas and electricity merger



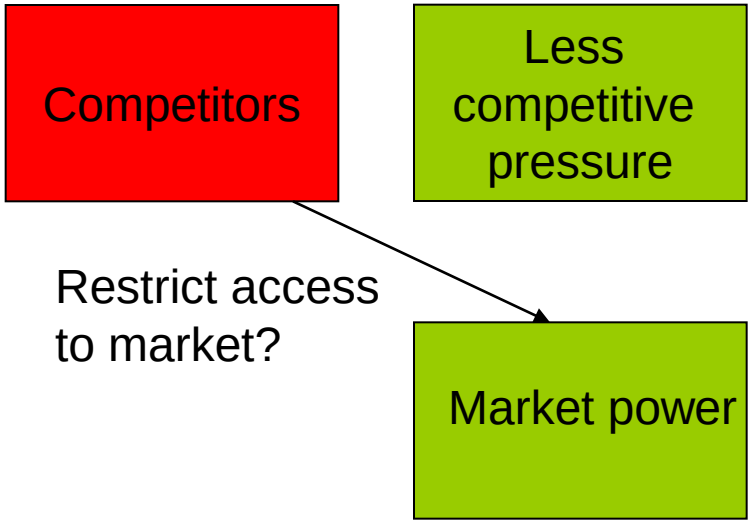
Heat and power production

B. Customer foreclosure

Input foreclosure

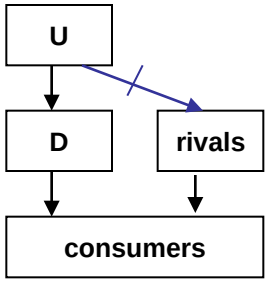


Customer foreclosure

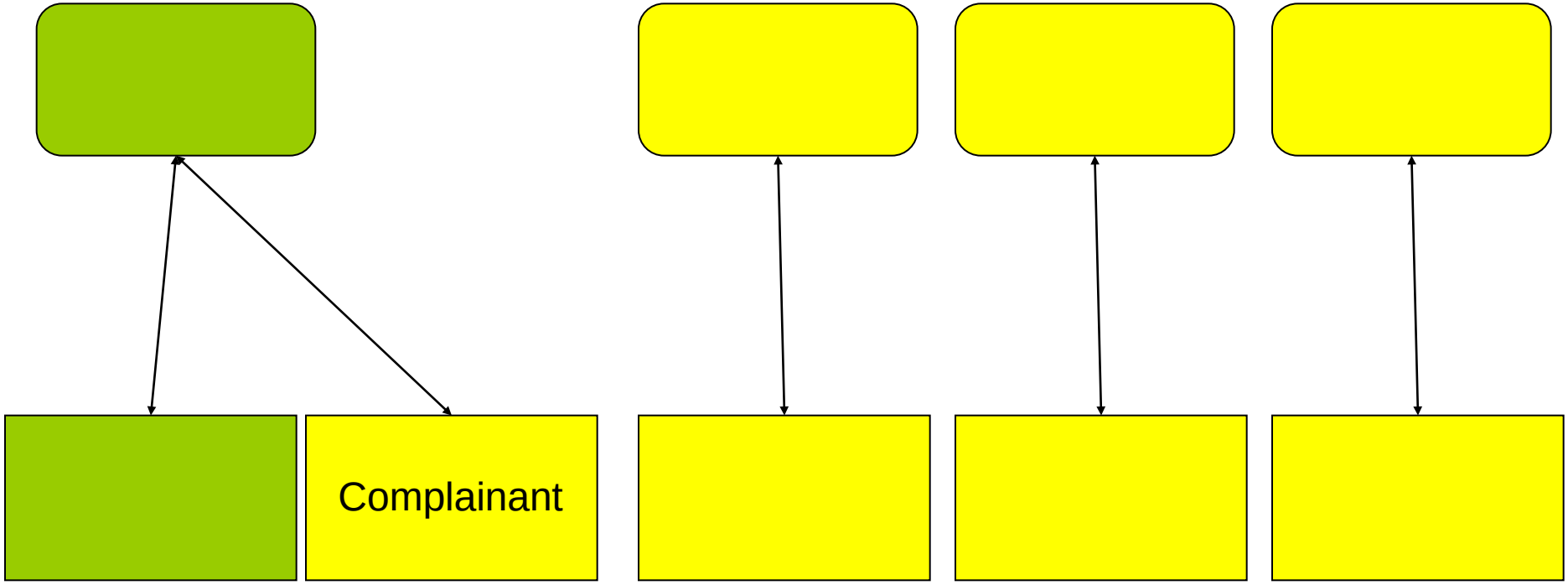


Consumer welfare

- 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