

**Comments of the  
Business and Industry Advisory Committee (BIAC) Competition Committee  
to the European Commission  
on its  
Draft Commission Guidelines on the Assessment of Non-Horizontal Mergers**

**May 24, 2007**

**I. Introduction**

1. The Competition Committee of BIAC, the Business and Industry Advisory Committee to the OECD, welcomes the opportunity to comment on the European Commission's Draft Guidelines on the Assessment of Non-Horizontal Mergers, hereinafter "the draft Notice."
2. The predominance of non-horizontal mergers are entered into by firms to lower their costs and compete more effectively and do not warrant any detailed analysis under merger control law. Indeed, in the vast majority of cases, a simple, straightforward preliminary analysis suffices to confidently label a non-horizontal merger as either efficiency enhancing or, at a minimum, competitively neutral, and to dispense with any further regulatory review. In the few cases that might, following a proper preliminary analysis, potentially give rise to negative effects, the evaluation of the precise impact of the merger over time is inherently more complicated. The principal reason is that the first order benefits that allow the combined entity to increase output to the benefit of consumers are likely to be direct, while anticompetitive effects, if any, are dependent on a the occurrence of a number of variables that are likely to occur only after a considerable length of time. As a consequence, the reviewing agency should proceed with great caution when analysing potential negative effects arising from these types of transactions and be particularly careful not to arrive at false positive findings. The risk of over-enforcement is particularly significant in this area of the law.
3. When reviewing non-horizontal mergers, the agency should concentrate on the precise reasons why the single profit theorem would fail to apply to the case at hand and postulate a credible, robust theory of harm that is consistent with the facts, that predicts with sufficient certainty that the long term anticompetitive effects dominate the inherent elimination of double marginalisation and other (price) efficiencies and that, finally, factors non-price and (other) dynamic efficiencies adequately into the analysis. One key observation in this respect is that, because the identification and articulation of the theory of harm, as well as the identification and quantification of the actual effects, are so important in these types of cases, the use of structural assumptions and proxies for (future) competitive harm should be avoided. While this method of enforcement may perhaps be appropriate in other areas, it hardly lends itself for application in the field of non-horizontal mergers.
4. An over-inclusive, too interventionist enforcement policy in the area of non-horizontal mergers may defeat significant dynamic efficiencies. These efficiencies, which may materialize only some time after the merger has been implemented and that are often difficult to quantify at the time the merger is entered into, are nonetheless often continuing in nature. It

is therefore of great importance not to skew the analysis towards short-term price-efficiencies or negative effects. This consideration implies that the framework of analysis for non-horizontal mergers should be particularly geared towards the evaluation of the importance of (technical) barriers to entry and expansion, the availability of effective counterstrategies and, of course, the dynamic efficiencies themselves. As part of the theory of harm, the reviewing agency should, in BIAC's view, make clear which types of counterstrategies it will consider and to a reasonable extent be obligated to explain why those strategies are not available in the case at hand or are insufficient to address perceived competitive harm.

5. Recently, at the occasion of the OECD Competition Committee Roundtable on Vertical Mergers in Paris on February 22, 2007, BIAC submitted its views on the treatment of vertical mergers. In many respects, those observations reflect BIAC's position on the subject of non-horizontal mergers in general. BIAC's comments to the OECD Competition Committee are attached to this paper for the Commission's convenience as "Attachment 1." Because the OECD Secretariat's position paper, reflects, as we understand it, the views of Professor Church on the preparation of the draft Guidelines, we believe that the BIAC comments are quite relevant and BIAC respectfully refers the Commission services to that paper. Below, BIAC will comment briefly on the points of the draft Notice that it believes merit specific attention.
6. One general point to note is that the current breadth of the discussion contained in the draft Guidelines may detract from their effectiveness. Providing effective guidance to the business community requires that the Commission's statement of policy and, effectively, enforcement intention be clear, concise and comprehensible, even when dealing with complex subjects. For example, statements of underlying economic principle are to be applauded, but generally are less useful than statements regarding the Commission's mode of factual and analytical analysis. Likewise, expounding on debatable or untested theories of harm is of little practical utility. In essence, if the Commission does not yet know how to treat certain structural and factual circumstances –or wishes to retain flexibility in that respect-, it should withhold stating its enforcement intentions in this regard. Devoting substantial attention to streamlining the draft Guidelines will help to assure the utility and credibility of the Commission's efforts. It will also facilitate the efficient use of Commission resources by aiding companies in identifying and avoiding problematic transactions. We would be happy to identify provisions that may usefully be streamlined in this respect.

## **II. Foreclosure**

7. Current economic insights concentrate on how input and customer foreclosure might raise rival's costs or reduce their revenues, whether those effects may result in negative effects on competitors and, if so, whether consumers are likely to be harmed. As a matter of principle, the potential for foreclosure is a legitimate theory of harm and can serve as an appropriate basis for enforcement. BIAC welcomes the Commission's general acknowledgment in the draft Notice that it will carefully evaluate the ability and incentive of the merged company to foreclose rivals, as well as the overall effect on competition by way of a potential reduction of consumer welfare. The analytical approach suggested in the draft Notice nonetheless calls for a number of observations.
8. First, it is essential that a decision to block a vertical or conglomerate merger is based on a comprehensive, robust theory of harm that is based on consistent facts and that it is specifically articulated in the Commission's decision. The articulation of the theory of harm

that applies to a specific set of facts is particularly important. While the Commission is under a general duty to explain its decisions and, in the context of non-horizontal mergers, to clearly identify the specific chain of events that will lead to consumer harm, it would be helpful if the definitive Notice would nonetheless clearly state that the finding of consumer harm in these type of cases requires a coherent and robust theory of harm. Such a statement, for example in Section II of the draft Notice, would send a valuable signal to the international business community and would be in line with the recommendations of the EAGCP.<sup>1</sup> Moreover, it would place paragraph 33 of the draft Notice in a more positive context. On a more general level, the draft Notice would benefit from a general statement in Section II, for instance at the end of paragraph 11, that would make clear that competitive harm as a result of non-horizontal mergers only occurs exceptionally and that, as a result, a finding of competitive harm requires a cogent explanation as to why the general economic theorem which anticipates that vertical integration will generally result in the elimination of double marginalisation does not hold or is outweighed in the case at hand.

9. Second, the draft Notice contains an overview of the general analytical framework and discusses a great number of factors that the Commission will take into account when assessing non-horizontal mergers. However, the draft Notice is too cautious in distinguishing between “less likely” and “more likely” theories of harm. In view of the current state of economic insights, BIAC believes that it would in particular be reasonable to (i) start paragraph 37 with the qualification “Exceptionally, ” (as the OSS model that underlies that paragraph is highly stylized and subject to significant criticism); (ii) to add to paragraph 58 that customer foreclosure, as in the case for input foreclosure, may under certain circumstances lead to competitive harm, but that customer foreclosure presents a more limited potential for prices to rise in the short run;<sup>2</sup> and (iii) that coordinated effects, both in the context of vertical and conglomerate mergers, are equally exceptional. It should also be considered, as noted above, whether to dispense with the discussion of theories of harm that are extremely unlikely to occur in practice or without empirical precedent.
10. Generally, for a foreclosure strategy to be profitable, competitors must be unable to adequately respond to the merger. In its submission to the OECD Roundtable on Vertical Mergers, BIAC stressed the importance of a detailed evaluation of counterstrategies available to competitors and noted that, under specific circumstances may even lead to a more competitive market outcome.<sup>3</sup> As a result, the analysis of the likely responses and counterstrategies of rivals is an essential step in the analysis of any non-horizontal merger. It would be helpful if the final Notice would acknowledge the principle that the competitive process itself reflects that competitors often will respond to a change in the conduct of a competitor that can potentially undo any potential negative effects or can otherwise prevent the merged entity from entering into a profitable anticompetitive foreclosure strategy. As part of a comprehensive theory of harm, the Commission should explain why it believes that effective counterstrategies are not available or not sufficient to counter any negative effects. Failure to fully incorporate this premise suggests that the Commission will undertake only a static, backward-looking analysis, which does not reflect actual market dynamics. As the

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<sup>1</sup> See, in particular, EAGCP, “Non-Horizontal Merger Guidelines: ten Principles, A Note by the EAGCP Merger Sub-Group,” August 17, 2006, point 3 (“... the implication is that the appropriate theory of competitive harm must be particularly carefully “tuned” to the merger in question, specifying the mechanisms through which harm would be likely to occur.”).

<sup>2</sup> See, Attachment 1, BIAC paper to the OECD, para 16.

<sup>3</sup> See, Attachment 1, BIAC paper to the OECD, para 25-27.

Commission has demonstrated in most cases that it will indeed critically review possible competitive reactions from rivals, there does not seem to be any reason why this necessary analytical step could not be more firmly established in the final Notice.

11. In view of the above, the present wording of the draft Notice could – and should – therefore be amended in the sense that it would make clear (i) that the evaluation of counterstrategies is an essential step in the analysis of any non-horizontal merger; (ii) that the Commission “will,” rather than “may” (as stated in paragraphs 38 and 66, compare paragraph 102 ) consider counterstrategies; and (iii) that the range of possible counterstrategies may include any type of conduct, including counter-mergers, non-structural cooperation or integration, as well as potential expansion and entry into upstream-downstream of related markets. The language of the draft Notice does not cover these latter types of counterstrategies explicitly.
12. Paragraph 101 of the draft Notice states that as part of its analysis of the profitability of a tying and bundling strategy, the Commission will consider whether the merged entity can commit to the strategy. BIAC suggests to point out in a more general manner that the commitment – in the game-theoretic sense – to engage in a certain course of action, is a prerequisite for competitive harm to occur.
13. BIAC invites the Commission to carefully review the necessary conditions for, in particular, input foreclosure and customer foreclosure. A clear identification of the key indicators for a possible anticompetitive strategy would enhance the practicability of the future Notice and would contribute to a transparent enforcement policy in this field. The current text of the draft Notice states that for input foreclosure to occur, market power in the upstream market is a precondition.<sup>4</sup> In contrast, the section of customer foreclosure is less clear with regard to the minimum conditions (paragraph 60) and seems to suggest that the mere involvement in the merger of some – unquantified – “important” customer (paragraph 60), together with economies of scale and scope (paragraph 61) would be sufficient.<sup>5</sup> BIAC suggests that these latter conditions for customer foreclosure be clarified. In particular, it would be helpful to know whether the Commission requires market power downstream in the conventional meaning of the notion, as BIAC believes is reflected in the economic literature, or whether “something less” than market power downstream could trigger any customer foreclosure concerns.
14. BIAC believes that the Commission should more clearly identify the conditions required in the related vertical market in order for an anticompetitive foreclosure strategy to be implemented successfully. In our view, it should be stated in the definitive Notice that customer and input foreclosure occur under very specific circumstances and generally require, in addition to significant market power upstream (in the case of input foreclosure) or downstream (in the case of customer foreclosure), that the combined entity would either have a substantial market share in the other vertically related market, or that that other market would be conducive to the exercise of market power post-merger by the combined entity.<sup>6</sup>

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<sup>4</sup> BIAC suggests that it be made clear in paragraphs 34-38 that there must be significant market power for any negative effects to occur.

<sup>5</sup> See also, paragraph 98 (“The effects of bundling or tying can only be expected to be substantial when at least one of the merging parties’ products is viewed by *many* customers as *particularly important* and there are few relevant alternatives for that product....”).

<sup>6</sup> Relatedly, if the vertical merger combines firms that have a substantial share in each of the respective upstream and downstream markets, the prospect for significant efficiencies is likely to be high, which may reduce the prospect for net anticompetitive effects, all other things remaining equal.

BIAC suggests that paragraphs 42 and 69 should be modified accordingly. In addition, paragraph 42 should state that the incentive to foreclose “will,” rather than “may” depend on these factors.

15. Finally, BIAC notes that a clear identification of the preconditions for competitive harm is also important in view of the operation of the safe harbour of paragraph 25 of the draft Notice. In this respect, it is suggested to make more explicit which markets the Commission will consider as “markets concerned” within the meaning of that paragraph.<sup>7</sup> This applies in particular to vertical mergers that may give rise to customer foreclosure and conglomerate mergers, where the notion of “markets concerned” could arguably be applied to the entire range of products of the merging parties. Clearly, such an interpretation would be incorrect and impracticable because the same conditions are not likely to apply equally or possibly at all in every market concerned.
16. Finally, while BIAC appreciates that the likely negative effects associated with non-horizontal mergers may be difficult to quantify, it urges the Commission to critically review the present draft Notice and, wherever possible, to indicate more clearly that, as part of its analysis, it will seek to quantify those negative effects. BIAC is concerned that, as presently drafted, the Notice, in particularly paragraphs 18 and 28, would enable the Commission to block non-horizontal mergers, by merely demonstrating some unquantified measure of “anticompetitive foreclosure,” without ascertaining whether and by how much the expected long-term harm would outweigh the claimed short-term gains. The uncertainty that the draft Notice brings about in this respect is not only of a general concern, but particularly worrying where – pursuant to paragraph 64 – the Commission may believe that a (customer) foreclosure would “reduce the incentive of rivals to invest in research and development and product quality that would hamper their ability to compete in the long run,” without articulating more precisely when that might be the case.
17. A greater willingness to consider the magnitude of negative effects would, moreover, be consistent with the strict requirements that the draft Notice suggests with respect to the quantification of efficiencies, would send a reassuring signal to the international business community and would bring the methodology more in line with, for example, the framework advocated by Professor Nalebuff, who – in the case of bundling – *inter alia* suggests to quantify the expected damage if, as a result of a bundling strategy, prices are likely to rise.<sup>8</sup>

### **III. The Treatment of Efficiencies**

18. The consideration of efficiencies is integral to the analysis of non-horizontal mergers, and BIAC believes that the draft Notice can be improved upon by making clear that the assessment of efficiencies can not be disentangled from the anticompetitive effects and that, as a consequence, the analysis of non-horizontal mergers cannot be conducted in a two-stage approach. Nor would it be appropriate to suggest that a higher standard of proof should be

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<sup>7</sup> In particular, would a vertical merger involving a non-dominant upstream firm and an “important” downstream customer, which does not, however, have market power in the conventional sense of the meaning of the notion, qualify under the safe harbor of paragraph 25 of the draft Notice? Would it be different if the customer was not “important” but arguably did have market power? Does the analysis change if the upstream firm had (significant) market power?

<sup>8</sup> See, Nalebuff, DTI Economics Paper No. 1, Bundling, Tying and Portfolio Effects, Part 1- Conceptual Issues, pgs. 63-64.

applied to the demonstration of efficiencies than would be applied to the demonstration of potential consumer harm. The current text of the draft Notice does not, in BIAC's view, recognize that methodology sufficiently. Indeed, paragraphs 30, 31, 57, 76 and 113-116, in particular, could be modified in a simple manner to elucidate that the Commission (i) "will" consider efficiencies and (ii) "will" conduct a comprehensive analysis.

19. As is almost universally accepted, the starting point for the analysis of non-horizontal mergers is the likelihood that these types of transactions will reduce or eliminate some level of costs or bring about other static or dynamic efficiencies. An approach that requires the parties to quantify the efficiencies prior to the acquisition in great detail, or would inappropriately subject efficiency claims to the strict conditions mentioned in paragraph 53 of the draft Notice, would not be consistent with this starting point. BIAC believes that the application of these requirements may be appropriate in the context of horizontal mergers, but it fails to serve any meaningful purpose in the context of vertical and conglomerate mergers. In essence, because cost-reductions are highly likely to result from most non-horizontal mergers, and because anticompetitive harm is highly unlikely to result from most non-horizontal mergers, and because harm cannot occur except in those situations in which the prospect for efficiencies is also present, the Notice should unify the analysis of these points on the same analytical and evidentiary footing.
20. BIAC supports the principle that the Commission should bear the responsibility of establishing each element of proof required to sustain a decision to challenge a non-horizontal transaction. This principle is required in order to ensure that the decisions of the Commission are not viewed as arbitrary and, at the same time, carry the necessary weight expected of important decisions that will shape the behaviour of parties evaluating future non-horizontal mergers. This position is in line with US practise in the field of non-horizontal mergers in which the FTC or DOJ bears the burden of establishing all of the prima facie elements of a violation of Section 7 of the Clayton Act. The draft Notice should embrace this position.<sup>9</sup>
21. BIAC submits that, in these circumstances, there are a number of methods available for the Commission to assess the magnitude of the efficiencies.<sup>10</sup> In this respect, BIAC also refers to the methodology for quantifying efficiencies that the Commission has laid down in its Notice on the application of Article 81(3)<sup>11</sup> and the suggestions made by the study which the Commission has recently commissioned to facilitate the practical application of the efficiency test under Article 81(3).<sup>12</sup>
22. Finally, BIAC would welcome an appropriately qualified statement to the effect that the Commission will only rarely (if ever) conclude that anticompetitive concerns exist in the presence of compelling merger specific non-price efficiencies, in particular dynamic efficiencies.<sup>13</sup> Again, such a statement would convey an encouraging signal to many firms

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<sup>9</sup> This burden of proof should include -- in the extraordinary situation where the Commission may take the view that the efficiencies themselves may give rise to competitive harm -- the burden on the Commission to quantify and verify the efficiencies.

<sup>10</sup> See, Attachment 1, BIAC paper to OECD WP3, paragraphs 53- 57.

<sup>11</sup> Commission Notice, Guidelines on the application of Article 81(3) of the Treaty, 2004 O.J. (C 101) 97.

<sup>12</sup> DG Enterprise and Industry, "Practical Methods to Assess Efficiency Gains in the Context of Article 81(3) of the EC Treaty," Final Report by Copenhagen Economics.

<sup>13</sup> See also, the suggestions made by Professor Jeffrey Church at the occasion of the ENCORE Workshop on the Assessment of Non-Horizontal Mergers on April 26, 2007 in The Hague, The Netherlands.

that contemplate entering into non-horizontal mergers for these reasons and might place the Commission's overall treatment of non-horizontal mergers in a much more positive light and reduce the risk that these Guidelines will have a chilling effect on businesses seeking to pursue what are, in practice, generally benign transactions from a competition standpoint.

#### **IV. The Safe Harbour**

23. BIAC is of the opinion that the suggested safe harbour provisions in paragraph 25 of the draft Notice are too narrow and suggests to significantly increase the tentative market share threshold of 30%. Such an approach would be consistent with the prevailing economic insights and models that negative effects generally require a significant degree of market power and, in many circumstances, even dominance/monopoly power and would significantly enhance the practicability of the draft Notice. In connection therewith, the draft Notice would benefit from a general statement to this effect in Section II (Overview), paragraphs 34, paragraphs 57-76 (customer foreclosure), and paragraph 98 (conglomerate mergers). An increase of the market share threshold could be accompanied by a statement that the safe harbour would not apply to coordinated effects, or the (oligopolistic) situations covered by the Ordovery/Saloner/Salop model or that the Commission may evaluate those (exceptional) situations without regard to the safe harbour provisions.

#### **V. Final Observations**

24. BIAC submits that the Commission should critically reconsider the draft Notice's sections on coordinated effects (paragraphs 78-89 and 117-119) and conglomerate mergers. These sections, as currently drafted, reflect the relatively limited practical enforcement experience or empirical evidence in these areas as compared to vertical foreclosure. Narrowing the discussion of these areas to reflect practical, as compared to theoretical, harm may enhance the overall utility of the Guidelines. In particular, BIAC suggests that – in view of the highly exceptional possibility that vertical mergers give rise to coordinated effects – the sections on coordinated effect would clearly indicate that these effects are truly exceptional and that, in most cases, the “least unlikely” mechanism for coordinated effects would consist in the elimination of a maverick firm. With regard to the section on conglomerate mergers, BIAC suggests to define the notion of a “more vulnerable position” in paragraph 118 more precisely and to clearly indicate in paragraph 119 that the mere increase in “multi-market contacts” does not in itself give rise to any presumption with respect to coordinated effects.

## **Attachment 1**

**Discussion Points**

**Presented by the Business and Industry Advisory Committee (BIAC) to the  
OECD Competition Committee**

**Roundtable on Vertical Mergers \***

**February 22, 2007**

1. BIAC welcomes the opportunity to comment on the issue of vertical mergers.

**I. Introduction**

2. Vertical integration is an important vehicle used by firms to lower their costs and compete more effectively. Thus, vertical mergers presumptively should be viewed as competition-enhancing arrangements and should not be subjected to regulatory intervention absent extraordinary circumstances that demonstrate a significant likelihood of competitive harm.
3. As a firm strives to innovate – both in terms of productivity and product selection – its need for inputs and distribution alternatives evolves, sometimes in ways that are unanticipated. Firms must make elections about the structure and organization of their company that will allow them to thrive in a dynamic and competitive marketplace. Indeed, firms that do not adapt are doomed to failure.
4. In establishing consumer welfare as the definitive objective of competition policy, competition laws should be applied to protect the competitive environment for firms striving for innovation and efficiency rather than protecting firms that adopt a static approach. Vertical mergers present a prime opportunity for inefficient firms to attack their competitors and seek the protection of regulators. Heeding these complaints, however, often will merely entrench the existing inefficiencies of the industry and prevent consumers from recognizing the benefits of innovation.
5. Striking the proper enforcement balance in the evaluation of vertical mergers need not be difficult. To optimise consumer welfare, we respectfully suggest that agencies should observe the following principles in considering vertical mergers.
  - a. Vertical mergers should be recognized principally as cost-reducing, efficiency enhancing transactions and presumptively should be viewed as beneficial to competition.

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\* Paper prepared by John Taladay, Partner, Howrey LLP, Paul Luard, Senior Vice President, Philips International B.V., and Derek Ridyard, Partner, RBB Economics, with a substantial contribution from Dr. Lawrence Wu, NERA, and BIAC Competition Committee members.

- b. Agencies should intervene in vertical mergers only in those exceptional circumstances where well-established theories of competitive harm and real-world factual conditions of the merger converge to demonstrate that a substantial likelihood of harm to consumers will occur.
- c. A conclusion that a vertical merger will result in significant competitive harm should not be reached without evaluating the counterstrategies available to rivals in the absence of regulatory intervention. Allowing the dynamics of a competitive market to play out is a preferable alternative to regulatory intervention and will result in the greatest enhancement to consumer welfare.
- d. Care should be taken to avoid the “chilling effects” of Type II error which will discourage or delay other firms from pursuing strategies and organizational structures that enable them to reduce costs and compete more effectively. The risks of over-enforcement are particularly significant in the area of non-horizontal mergers.
- e. Theories of economic harm in vertical mergers based on other than input foreclosure and customer foreclosure – even those that may be sound in theory – have significant limitations and should be approached with considerable scepticism.
- f. The elimination of double marginalization is a first order benefit that should be recognized as a laudable motivating factor for vertical mergers.
- g. The analysis of efficiencies should be an integral part of analyzing whether anticompetitive effects will result from vertical mergers.

6. Each of these considerations is discussed below.

## **II. Assessing Potential Competitive Harm**

7. Because of the competitive benefits that stem from inherent efficiency gains, vertical mergers will rarely present factual circumstances which suggest that competitive harm is likely. The analysis below focuses on the two principal theories on which vertical mergers should be analyzed: (a) input foreclosure and (b) customer foreclosure.

### ***A. Vertical Mergers and the Potential for Input Foreclosure***

- 8. The potential for input foreclosure is one of the principal theories of competitive harm and can serve as a legitimate basis for enforcement against vertical mergers. For competitive harm to occur as a result of input foreclosure, however, a number of market factors must be considered and particular conditions must be satisfied.
- 9. First, for input foreclosure to be an applicable theory of harm, the upstream firm must be able to raise the input price to downstream rivals either directly or indirectly.<sup>1</sup> This is not likely if the upstream market remains sufficiently competitive and if downstream firms can substitute easily to alternative inputs. In other words, the analysis should include an assessment of market power in both the upstream market and the downstream market(s). The factors that

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<sup>1</sup> The upstream market typically refers to firms that supply inputs, while the downstream market typically refers to firms that produce the product or service that encompasses the input and is sold to the final customer

would enter into such an analysis include a comprehensive examination of the upstream suppliers and their ability and incentive to continue selling to downstream customers. In addition, evidence that downstream customers already purchase from multiple upstream suppliers suggests that switching costs are low for downstream customers. Low switching costs would allow the downstream firms to turn to alternative suppliers if faced with a price increase from the merged entity.

10. Second, for input foreclosure to harm competition, an increase in the input price charged by the integrated or merged firm to downstream customers must also lead to an increase in the price charged by the downstream firms to their customers.<sup>2</sup> The reason is that absent an increase in the output price of the downstream firms, the incentive to increase the price of the input in order to implement a raising rival's cost strategy vanishes. As several models note, the benefit to a vertically integrated firm that engages in a strategy of input foreclosure is the higher profit margin downstream, which can only result if the price of the downstream industry's product is higher. Whether such a pass through is likely depends on a careful assessment of the product market in which the downstream firms compete. For instance, the downstream firms who purchase the merged entity's inputs could well face competition from rivals who sell products based on different technologies and inputs.
11. Third, even if a strategy of input foreclosure is likely to increase the merged firm's downstream profit margins, the increase in downstream profits for the merged firm must be greater than the cost of the strategy, i.e., the loss in upstream profits. This cost, which stems from the vertically integrated firm's decision to forego sales of its product to downstream rivals, for example, cannot be ignored. Yet for an input foreclosure strategy to be rational, the analysis must consider the balancing of the two opposing effects: higher downstream profits at the cost of lower upstream profits. The costs of exclusionary strategies are real and immediate and, as such, have the effect of lessening the incentives to deploy such strategies in a wide variety of market scenarios.
12. A fourth, but related, condition is that the vertically integrated firm must be able to commit to a post-integration strategy of foreclosure. Commitment is a critical component of the theory as it ensures the rationality of an anticompetitive input foreclosure strategy. Otherwise, the vertically integrated firm could well find it optimal to continue supplying its downstream rivals.
13. Fifth, for input foreclosure to have a competitive effect, counterstrategies that avoid foreclosure must not be available to the allegedly foreclosed rivals. As noted above, the ability of downstream rivals to merge with rival upstream suppliers could well stimulate competition or reverse the exclusionary strategy that was allegedly made possible by the transaction.
14. Sixth, the vertical merger is likely to yield efficiencies, which would include the possible elimination of double marginalization. As noted earlier, the conditions in which the efficiencies are likely to be most significant are also the conditions that are likely to create the opportunity for foreclosure. In addition, vertical integration could reduce the integrated firm's costs and improve the firm's productivity. Such benefits would counter the risk of competitive harm.

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<sup>2</sup> A price squeeze that attempts to force other downstream firms from the market is a variation of this theory. During the period of the squeeze, the price charged by the downstream firms to their customers may not rise. However, the theory posits a price increase following the exit of the rivals being squeezed.

***B. Vertical Mergers and the Potential for Customer Foreclosure***

15. Under the conventional customer foreclosure hypothesis, the vertically integrated downstream firm no longer purchases supply from unintegrated upstream competitors, as all of its demand for inputs would be supplied by its upstream affiliate. In theory, the reduction in demand could limit the addressable market or the sales volume available to the integrated firm's upstream rivals, thereby affecting their ability to achieve economies of scale. As a result, over time, upstream rivals who are unable to implement a counterstrategy may exit the market. The analysis of customer foreclosure, which focuses on an integrated firm's ability to reduce its rivals' revenues by denying them access to customers, is similar to the framework described above for input foreclosure. For instance, an analysis of both input and customer foreclosure would involve an analysis of relevant market definition, the nature of the products sold, the competition among the firms in that market, and barriers to entry.
16. There are nonetheless important distinctions between the two theories of vertical foreclosure. Putting aside efficiencies, input foreclosure has the direct potential to lead to higher prices in the short run by raising the costs of the integrated firm's downstream rivals. In contrast, customer foreclosure presents a more limited potential for prices to rise in the short run. Prices would not rise until after there was sufficient exit from the industry by the unintegrated rivals, which is less likely to occur in the short run except in cases of monopsony. Because exit may not be immediate, the potential harm to competition due to customer foreclosure may not occur until much later, if at all.<sup>3</sup> Because the short run and long run effects are likely to differ, competition policy should treat and distinguish the two theories appropriately. The following market facts and conditions should be considered.
17. First, as noted above, for anticompetitive customer foreclosure to be credible, both the upstream *and* downstream markets must be conducive to the exercise of market power. In particular, the analysis should focus on the merged firm's ability to control access to the ultimate customer or end user. Factors that would enter into such an analysis include the various ways in which the ultimate end users or customers obtain the product or service they want to purchase and the extent to which they can purchase those products and services without going through the merged entity. This implies a careful assessment of the variety of ways in which products are sold into the downstream market and the available methods of distribution.
18. Second, customer foreclosure is not likely if the cost of switching is relatively low. For instance, consider a theory where a first mover may be able to lock up customers, thereby denying a new entrant sufficient volume to realize economies of scale. Whether, in fact, customers are locked in to the first mover will depend on a variety of factors, such as the terms and duration of supply contracts and the dynamics of contract renegotiations.<sup>4</sup>

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<sup>3</sup> If this were to occur, downstream firms may be able to turn to rival upstream suppliers. Depending on the circumstances, this could take time and require costly investments. Moreover, additional time may be required if entry into the upstream market is needed to provide the non-integrated downstream firms with competitive upstream supply.

<sup>4</sup> For example, the European Commission addressed this issue in the context of the barriers to entry encountered in the energy sector. In its recent decision blocking the proposed acquisition by Energias de Portugal (EDP) a Spanish electricity provider, of Gas de Portugal (GDP), the Commission concluded that, after the acquisition, EDP would have the incentive to source all of its supply from its upstream integrated partner, GDP. In its analysis, the Commission determined that there would not be sufficient new gas demand from other power producers, and

19. Third, the analysis also should consider whether the potentially foreclosed rival firms are as efficient as the integrated entity, as harm to competition, under normal circumstances, would require, at a minimum, the elimination of unintegrated rivals who are at least as efficient as the integrated firm prior to the attempted foreclosure.
20. Fourth, whether harm to competition is likely will depend on the cost structure of the integrated firm's upstream rivals. This analysis would include an assessment of the economies of scale and scope of the upstream rival suppliers, as well as the relative efficiency of those firms.<sup>5</sup> Moreover, the analysis would consider the timing and likelihood of exit by the unintegrated rivals, as this is the first step that could allow the integrated firm to raise its prices. Together, these are factors that would affect the integrated firm's ability to place its upstream rivals at a disadvantage in a way that would lead to higher prices.
21. Fifth, for anticompetitive foreclosure to be a viable theory, the framework of analysis should include an assessment of the natural equilibrium that would result had there been no vertical merger or no attempted foreclosure. It is possible, for instance, that exclusive contracting is the natural equilibrium, in which case the vertical merger would not effectively change the structure of the marketplace. However, even though the structure of the market may be similar, a merger may change the incentives sufficiently so that prices may be lower and overall market output may be higher.
22. Sixth, the analysis must consider the incentives of the integrated firm to engage in customer foreclosure. This would involve an assessment of the costs and profit margins of the integrated firm's downstream unit, as well as customer demand for the downstream products. For example, if the downstream firm can make additional profits by purchasing a rival upstream firm's product and selling it to its downstream customers because, for instance, the quality of the product is higher, then customer foreclosure would not be a credible theory. That is because the integrated firm would continue to have an incentive to purchase products from rival upstream suppliers.
23. Seventh, the extent to which the integrated upstream firm is likely to react to downstream pricing is also an important factor. The counterstrategies available to the unintegrated firms need to be assessed. Because there are likely to be strategic reactions, the analysis will likely involve consideration of facts such as the own- and cross-price elasticities of demand for the various products in the marketplace, as well as the capacity and ability of rival firms to respond competitively.

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concluded that none of the commitments offered were sufficient to eliminate the customer foreclosure effect of the proposed concentration. (Case No COMP/M.3440 ENI/EDP/GDP, 09/12/2004; affirmed by the Court of First Instance in Case T-87/05, 21 September 2005.)

<sup>5</sup> The danger in not performing this type of analysis carefully was described in the recently published DG Comp Merger Remedies Study. The study noted, without identifying the transaction, that in "a rare instance of potential customer foreclosure, the remedy required the complete divestiture of the merging parties' activities in the (small) upstream market. That way, the merging parties' only competitor in the upstream market could not be foreclosed from its customer base, specifically, the merging parties. In this case (as in any other vertical case), the complete divestiture of the activities in one of the vertically related markets resolved the foreclosure concerns; however, the purchaser experienced considerable difficulties in attempting to establish itself in the market, and reported that its survival remains uncertain." (Merger Remedies Study, DG Comp Staff paper, Alex Kopke, Katharina Kraak, Damien Levie (DG ENTR), Justin Menezes, Sandra Plas, Walter Tretton, (October 2005), ¶17, p. 30.)

24. Eighth, a vertical merger is likely to generate efficiencies and cost savings. This would include the possible elimination of double marginalization. Again, as noted earlier, the conditions in which the efficiencies are likely to be most significant are also the conditions that are likely to create the opportunity for foreclosure. In addition, vertical integration could reduce the integrated firm's costs, improve the firm's productivity, and reduce transaction costs for the ultimate customer or end user. Such benefits could counter the risk of competitive harm.

### **III. Accounting for the Competitive Responses and Counterstrategies of Rivals**

25. Foreclosure is the principal theory of competitive harm for many vertical transactions. Yet most of the economic models of competitive harm in vertical mergers do not account for the competitive responses and counterstrategies by the potentially foreclosed competitors. Yet to assume away such a response is not realistic. Just as coordinated effects theory in horizontal mergers requires a conclusion that a competitive response will occur to a change in the behaviour of one competitor, a competitive response to vertical integration must also be assumed. In order to remain competitive in the marketplace, the natural response of a competitor will be to implement a counterstrategy to offset the competitive advantage (i.e., reduced cost) of its rival. The key question becomes whether in those rare instances where a vertical merger might pose competitive harm such competitive response will be sufficient to counter any competitive effect flowing from the vertical merger.

26. The net competitive impact of a vertical merger involves an assessment of the market dynamics and the counterstrategies that are available to other firms in the market. For example, consider a vertical merger involving an upstream firm and a downstream firm that creates the potential for input foreclosure or the prospect that a downstream firm may face higher input prices. Whether or not rival downstream firms are likely to be foreclosed depends in large part on their ability to deploy effective counterstrategies at non-prohibitive costs.<sup>6</sup> For instance, the downstream firm may be able to merge with another upstream firm to secure its supply of the input. If such a counterstrategy were available, the ultimate market outcome could well be more competitive than in the absence of the merger. Thus, despite industry consolidation resulting from two successive mergers, competition in the downstream market may well be more intense to the benefit of consumers. This is particularly important in industries characterized by systems competition.

27. The consideration of counterstrategies reflects that merging firms' rivals are often able to revise their market strategies, and possibly their own organizational structure, to account for changes in market circumstances.<sup>7</sup> Both the short run and long run consequences of a transaction are incorporated by this consideration. In some cases, a non-horizontal transaction could lead to lower prices in the short run, but higher prices in the long run. In other cases,

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<sup>6</sup> For a recent example under European merger control law where effective counterstrategies were deemed to exist, see Case No. COMP M. 4300 Philips- Intermagnetics.

<sup>7</sup> Whether the relevant counterstrategies include alliances, contractual arrangements, and other alternatives that do not require formal integration or a merger is best determined on a case by case basis. As noted above, the nature and magnitude of the vertical efficiencies of a merger are intrinsic to the transaction itself and the parties involved. Likewise, whether there is a non-merger counterstrategy that is likely to be relevant and effective in helping rivals to compete against the integrated firm will depend on the specific circumstances of the industry and the particular rivals involved in implementing such a strategy. Because the efficiencies are likely to be intrinsic to the parties involved, the mere presence of a viable non-merger counterstrategy does not imply that the efficiencies of integration are not merger-specific.

such an acquisition could put rivals at a “disadvantage” in the short run, but not in the long run as rivals develop new strategies and competitive responses. A failure to consider counterstrategies and rely instead on a static view of the market and the options of upstream and downstream rivals will result in both poor enforcement decisions and a loss of consumer welfare.

#### **IV. Avoiding Chilling Effects on Competitive Vertical Integration**

28. The chilling effects of enforcement against vertical mergers are greater than in many other areas of competition policy. At the same time, enforcement experience and the analysis of outcomes is much more limited than in horizontal mergers and other areas of competition law (e.g., cartels). Thus, both the risk and the cost of inaccurate enforcement decisions (particularly Type II error) should be recognized as heightened in the case of vertical mergers.
29. Enforcement decisions regarding vertical mergers have an important influence on the decisions made in the marketplace. Uncertainty can stem from a patchwork of enforcement initiatives that are at times only partially revealed to, or understood by, non-parties to a transaction. These actions influence not only those transactions that occur, but also those transactions that are being contemplated. Both Type I and Type II errors can lead to significant “chilling effects” and unintended injury to consumers.<sup>8</sup> Obviously, consumers may be particularly harmed if firms decide to forego non-horizontal transactions that may give rise to significant dynamic efficiencies.
30. Because of the collateral impact of enforcement actions, agencies should ensure that a high level of evidence exists with respect to the key factual and economic principles described above. Applying a high standard of proof prior to undertaking enforcement against vertical mergers will help to ensure that the net results of enforcement are in the best interests of consumers.
31. Conversely, then, without empirical evidence and practical experience to provide assurance that enforcement is well-justified, enforcement against vertical mergers may prove detrimental to consumer welfare. Thus, an established intersection of theory and practice is a prerequisite to sound enforcement, particularly in the field of vertical mergers. Enforcing against the marginal case, even if it results in an arguable elimination of instantaneous competitive effects, may have net adverse results when considering the chilling effect of the enforcement action.

#### **V. Limitations of Alternative Economic Models of Vertical Mergers**

32. Alternative models of economic harm for vertical mergers that rely on effects other than input foreclosure or customer foreclosure should be viewed with substantial scepticism.
33. Despite the fact that much of the economic literature on vertical relationships starts from the presumption that vertical transactions are driven by efficiency considerations, the potential for non-horizontal mergers to lower costs or enhance competition generally is not emphasized or given sufficient weight in most recent economic assessments of vertical mergers. In fact, the objective of these studies is often to consider how non-horizontal mergers might, in theory,

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<sup>8</sup> This point is specifically noted by Professor Church in his remarks to the Association of Competition Economists on September 8, 2005.

lead to competitive harm rather than to focus on the cost-benefit analysis of vertical mergers in a broader sense.

34. These recent studies of the economic models, including the Church Report of 2004, tend to focus on the “post-Chicago” literature. In general, these models focus on the potential for competitive harm rather than the potential for vertical mergers to improve static or dynamic efficiency and enhance competition. This is not a criticism of the Church Report or of the post-Chicago literature, but a reminder that the post-Chicago literature is focused on developing and explaining theories of competitive harm, which was a research goal that stemmed in part from the recognition that the Chicago School already laid out a strong case for the procompetitive rationale for vertical mergers. As a result, more recent studies tend to apply game-theoretic models in order to explore the conditions under which theoretical exceptions to the general presumption (that most vertical mergers generate efficiency gains) may exist, but the general rule is still widely credited – even by these recent studies.
35. Although the weight of post-Chicago economic analysis may skew towards the identification of market settings in which vertical arrangements could lead to potential competitive harm, a proper analytical framework should credit the potential for vertical mergers to increase economic efficiency and enhance competition. In this regard, agencies should recognize that (a) the elimination of double marginalization and other vertical inefficiencies are first-order benefits of a non-horizontal transaction; (b) the merger-related efficiencies and cost savings often arise because they resolve problems that cannot be solved practically through contractual solutions; (c) an empirical approach to estimating and assessing the magnitude of the efficiencies is an integral step of the analysis; and (d) the ability of rival firms to engage in counterstrategies that could further enhance competition in the marketplace is a key consideration.
36. These alternative models normally do not provide a sufficient basis for assessing competitive impact for several key reasons. First, the knowledge base regarding the competitive impact of vertical mergers is not sufficiently developed to identify the specific conditions under which a particular kind of transaction would likely harm competition. The conclusions that follow from many of the key models are not robust in that changes in assumptions can lead to very different conclusions. Consider, for example, the conclusions of a well-known model of vertical integration by Ordover, Saloner, and Salop. In that model, if downstream firms compete on prices of their differentiated products, then vertical mergers could be harmful to consumers; yet if the downstream competition took the form of “capacity competition” or “quantity competition” rather than price competition, then the opposite would be true.
37. Second, there are many categories of economic models, and many more specifications of those models, that can be used to describe the possible competitive impact of a particular transaction. Each will apply only to a very small fraction of cases, however, and the applicability of any particular model is likely to depend entirely on the facts. Regulatory review must identify and clearly articulate the theories that are useful in real world situations. In other words, regulatory action should rely on more than a theoretical harm. It must reflect demonstrable harm based on a sound theoretical foundation incorporating realistic assumptions that reflect the actual market facts and conditions.<sup>9</sup>

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<sup>9</sup> See also, EAGCP, “Non-Horizontal Merger Guidelines: Ten Principles, A Note by the EAGCP Merger Sub-Group,” August 17, 2006, point 3 (“...the implication is that the appropriate theory of competitive harm must be particularly carefully “tuned” to the merger in question, specifying the mechanisms through which such harm would be likely to occur.”).

38. Third, many of the economic theories yield only a partial picture of the likely effects of an actual vertical merger. For example, most, if not all, of the models do not account for efficiencies, new product introductions, and other benefits that might stem from a particular vertical transaction. Efficiencies are particularly important as the integration may have lowered costs, including transaction costs. Similarly, most models do not account for the possibility that competition could be more intense following vertical integration. Thus, a sound analysis of a vertical merger must look to account for dynamics that may not be accounted for in theoretical economic models.
39. Fourth, as described above, a vertical merger is likely to generate a broad array of efficiencies.<sup>10</sup> Thus, a proper competitive analysis of a vertical transaction requires an integrated consideration of the efficiencies and the potential for anticompetitive harm. This is complicated by the fact that these efficiencies in many cases, e.g., quality assurance, mitigating a holdup problem or dynamic efficiencies, are not readily quantifiable. But this does not relieve the burden of considering the efficiencies. A failure by an enforcement agency to evaluate the efficiencies in a vertical merger simply because they are difficult to quantifying would be equivalent to a failure to consider anticompetitive harm of a vertical merger because it is difficult to quantify. Both lost efficiencies and anticompetitive harm can lead to a reduction in consumer welfare and both must therefore be fully considered, particularly in a vertical merger where the two cannot be extricated.
40. Fifth, given the state of economic knowledge, enforcement actions should be based only on theories that are well established in the economic literature, e.g., input foreclosure, customer foreclosure, and tying. For these theories, it is uncontroversial that the potential for competitive harm exists. In practice, assessing the actual harm to competition (or the likelihood of such harm), and balancing the procompetitive benefits against the potential harm to competition, are the subjects of much debate.
41. Theories involving coordinated effects, financial leverage, financial predation, and the like are hypotheses that are relatively new compared to models of vertical foreclosure and tying. Given the state of this literature, it may be more appropriate to delay an assessment of these models to the future—after additional theoretical research and empirical study have become available—and to focus on the basic vertical merger models.

## **VI. The Elimination of Double Marginalization Is a First Order Benefit that Should Be Acknowledged**

42. When upstream and downstream firms are not integrated, the problem of double marginalization arises because each firm does not take into account the impact of adding a mark-up on the profit of the other firm. The volume of output purchased by the ultimate consumer is inefficiently reduced because the consumer price includes mark-ups (i.e., profit margins) imposed by both the downstream and upstream firms. In some cases, the retail prices could even exceed the monopoly price of the manufacturer's product. This result often can be avoided if vertical integration occurs.

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<sup>10</sup> The RBB Report, infra note 15, describes the variety of efficiencies that are often engendered by non-horizontal mergers.

43. A vertical merger can generate efficiencies by internalizing this externality and putting the downstream pricing decision in the hands of the upstream manufacturer (or a downstream retailer), which does not have an incentive to increase downstream prices above competitive joint profit-maximizing levels. In other words, an integrated entity maximizes its profits by eliminating the double markup, which leads to lower prices to end users and customers. There may be non-price benefits, as well, such as improved supply chain management, product scheduling, product improvements and new product innovation. These are first-order benefits to consumers, and they are benefits that are more likely when the downstream distributor or retailer may have market power.
44. The efficiencies associated with the elimination of double marginalization are intrinsic to a vertical merger—they lower the marginal costs of selling the downstream products, thereby inducing the integrated firm to lower downstream prices and to compete in selling the downstream products more vigorously.<sup>11</sup>
45. Theories of vertical foreclosure often require the presence of significant market power in both the upstream and downstream markets, as well as economies of scale and/or scope in both markets, which imply that there may be a gap between prices and marginal costs along the vertical chain of production and distribution. However, it is this gap that sets the stage for vertical integration to align the incentives of parties along the vertical supply chain and to eliminate double marginalization and other inefficiencies, with the effect of enhancing output and competition downstream. Thus, when the preconditions (e.g., market power) do not exist, vertical mergers should presumptively be viewed as likely to eliminate double marginalization to the benefit of consumers.
46. The empirical evidence suggests that vertical integration (and vertical restrictions generally) tends to benefit consumers. An authoritative recent survey concluded that “most studies show that vertical restraints increase (or at worst, do not reduce) economic welfare.”<sup>12</sup> These include studies that confirm that vertical integration (and vertical restraints) can reduce double marginalization and other costs.<sup>13</sup> The conclusions of this survey echo those reached by prominent practitioners and scholars who state that “the empirical evidence concerning the effects of vertical restraints on consumer wellbeing is surprisingly consistent. Specifically, it appears that when manufacturers choose to impose such restraints, not only do they make themselves better off, but they also typically allow consumers to benefit from higher quality products and better service provision.”<sup>14</sup>

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<sup>11</sup> These points (and the points that follow) have been made before by Robert Willig and B. Douglas Bernheim in presentations they have given on the economic foundations for vertical merger Guidelines in the U.S. Recently Farrell and Weiser have posited a more general formulation of the Cournot effect in dynamic market settings. See Farrell and Weiser, “Modularity, Vertical Integration and Open Access Policies: Towards a Convergence of Antitrust and Regulation in the Internet Age,” *Harvard Journal of Law and Technology*, 17 (2004), p. 86-134.

<sup>12</sup> James Cooper, Luke Froeb, Daniel O’Brien, and Michael Vita, “Vertical Restrictions and Antitrust Policy: What about the Evidence,” *Competition Policy International*, Vol. 1, No. 2, Autumn 2005, p. 48.

<sup>13</sup> *Id.*, p. 56-58.

<sup>14</sup> Francine LaFontaine and Margaret Slade, “Exclusive Contracts and Vertical Restraints: Empirical Evidence and Public Policy,” in *Handbook of Antitrust Economics* (forthcoming 2005), p. 22.

## **VII. Consideration of Efficiencies Is Integral to Vertical Merger Analysis**

47. For merger policy, the intrinsic nature of the efficiencies that arise from a vertical merger implies that an assessment of these efficiencies cannot be conducted using a “two stage” approach, as is often the case with a horizontal merger. The main reason is that it is difficult to disentangle the efficiencies from the anticompetitive effects as the two are inextricable. Thus, an explicit assessment of the potential efficiencies from the transaction is central to the entire competitive assessment. As noted in the RBB Report, “it will very often be the case that the source of efficiencies realised by the merging parties is also the source of the competition concern.”<sup>15</sup> This is particularly true when assessing the competitive issues surrounding the potential for foreclosure. This position is confirmed by, for instance, the Economic Advisory Group for Competition Policy (EAGCP).<sup>16</sup>
48. This does not suggest that a vertical transaction with significant efficiencies will necessarily give rise to any degree of anticompetitive effect. Rather, it suggests that the analysis of a vertical merger cannot properly proceed by first considering anticompetitive effects and later evaluating efficiencies. Rather, the analysis of efficiencies – and weight accorded to efficiencies in the analysis of a vertical merger – must be given primacy in the analysis of the merger’s potential competitive effect.
49. The starting point for understanding the competitive implications of a vertical merger is to recognize the likelihood that the transaction will reduce or eliminate the inefficiencies that can arise when the incentives of vertically-related parties are not aligned. Of course, even if the prospect for efficiencies is obvious, firms may not be able to quantify the efficiency gains easily; the acquirer may not have all of the information it needs from the target to do such a calculation or the market may be evolving so that such a computation is not possible. As a corollary, an approach that explicitly recognizes the efficiency-enhancing rationale for vertical transactions is called for, without requiring the acquirer to have quantified all of the efficiencies prior to the acquisition. This is because, as almost universally accepted in the literature, the prospect for vertical transactions to facilitate profitable anticompetitive market conduct is much more limited than in the case of horizontal transactions.

### ***A. Vertical Transactions Often Resolve Problems that Cannot be Solved Practically through Contractual Solutions***

50. Many vertical relationships that are based on contract – i.e., that do not involve integration through merger – are threatened by the prospect of opportunism and free riding. Opportunism occurs when one party (for instance, an upstream firm) can take advantage or “hold up” another party (such as, a downstream firm) after the downstream firm may have made investments that limit the ability of the firm to turn to alternative upstream suppliers. Free riding is another common problem that arises between upstream and downstream firms.<sup>17</sup> A vertical merger is one way to resolve the potential for opportunism and free riding.

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<sup>15</sup> RBB Economics, “The Efficiency-Enhancing Effects of Non-Horizontal Mergers,” p. 121.

<sup>16</sup> See, supra note 9, p. 5 (“The assessment of the effects of a vertical merger must not presume consumer harm and then look for countervailing efficiencies.”).

<sup>17</sup> For example, a manufacturer may be unwilling or less willing to invest the resources needed to promote the efforts of a downstream retailer if it believes that its rivals may benefit more than it will.

51. The benefits of a vertical merger are particularly important in situations where other ways to resolve the potential for opportunism or free riding are not likely to work. Consider, for example, the downstream firm (Firm A) that is unwilling to build a manufacturing line that can only use a relatively unique input sold by a single upstream supplier (Firm B). Firm A may be concerned that after it builds the manufacturing line, Firm B would take advantage of the situation and raise its prices. To resolve the potential for such hold up or opportunism, Firm A may want a long term contract that provides some protection against opportunistic price increases in the future. Firm A also may want an exclusive dealing arrangement, which would give it the assurance needed that the upstream supplier will not sell its product to competing downstream purchasers in a way that would diminish the return on Firm A's investment in the manufacturing line. Thus, a possible solution is a contract that specifies that the upstream firm B will supply Firm A, the downstream firm, exclusively. However, Firm B may be unwilling to limit itself to a single downstream purchaser because it may be costly in ways that limit its feasibility (e.g., by limiting Firm B's returns). Firm B may also be unwilling to engage in exclusive dealing because it may be well positioned to expand its output in ways that Firm A is not prepared, independently, to accommodate. In other words, even though contracting is one way to resolve problems related to opportunism (or free riding), it may be infeasible or impractical. These are circumstances in which vertical integration can be the only efficient solution as a means to aligning the incentives of the upstream and downstream parties in a way that encourages both parties to make the necessary commitments and investments that would benefit ultimate customers.
52. The discussion above highlights the importance of appreciating the rationale for a particular vertical merger, which often is an attempt to remedy or improve upon contractual arrangements that have failed to align the incentives or coordinate the actions of independent upstream and downstream parties. For instance, the goal of aligning the incentives of upstream and downstream parties is easy to state, but often too difficult or impractical to accomplish through contractual arrangements. Similarly, the provision of the technical information needed to assure product compatibility and interoperability is not always easy through contractual means, as it may involve the sharing of confidential or proprietary information.

***B. Empirical Assessment of the Magnitude of the Efficiencies***

53. Given the presumption to be afforded to efficiencies, parties to a vertical merger should not be required to conduct an empirical assessment of efficiencies in order to gain approval, even in those rare cases in which competitive harm is conceivable. However, in order to reach an informed judgment that a vertical merger is – on balance – harmful, agencies should consider the extent to which the efficiencies can be quantified in order to provide assurance that an enforcement action will not unnecessarily eliminate significant consumer benefits.
54. The empirical literature provides a useful starting point for identifying the magnitudes of efficiencies that should be considered, as there are a number of studies that attempt to estimate the cost savings and efficiencies of vertical mergers and vertical restraints. Indeed, the literature shows that there are a number of methodological approaches that can and have been used.<sup>18</sup> If reliable data are available to quantify efficiencies, an assessment of the vertical

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<sup>18</sup> See, for example, Francine LaFontaine and Margaret Slade, "Exclusive Contracts and Vertical Restraints: Empirical Evidence and Public Policy," in Handbook of Antitrust Economics (2005); James Cooper, Luke Froeb, Daniel O'Brien, and Michael Vita, "Vertical Antitrust Policy as a Problem of Inference," Vanderbilt University Law School Law and Economics, Working Paper Number 05-12, (February 18, 2005); William S. Comanor, F.M. Scherer, and Robert L. Steiner, "Vertical Antitrust Policy as a Problem of Inference: The Response of the American Antitrust

efficiencies may involve an analysis of the prices, costs, and profit margins of unintegrated parties at the various levels of the vertical supply chain at issue and a comparison of these data to the actual or anticipated prices, costs, and profit margins of integrated entities in the marketplace. As an example, it may be possible to compare the prices charged by other integrated firms in the market to the total price that customers are or would be charged by single product sellers. The difference in prices would be an estimate of the cost savings to customers from integration. In this respect it is also noteworthy that the European Commission has recently commissioned a study to facilitate the practical application of the efficiency test under Article 81(3) of the Treaty.<sup>19</sup>

55. The analysis should not focus solely on prices and profits – there also may be empirical data from prior transactions that may be helpful in assessing the organizational and supply chain efficiencies. Similarly, it may be possible to show the nature of the vertical inefficiencies by analyzing the experience of two unintegrated parties who may have teamed together to produce a product or service—delays in getting a new product to market due to coordination failures, cost overruns, or the number of customer complaints may be informative. Even if these natural experiments do not quantify the efficiency itself, they can be helpful in demonstrating the rationale for the transaction or the vertical inefficiency that the transaction is intending to resolve.
56. It may be harder to assess the efficiencies resulting from the elimination of opportunistic behaviour. However, by acknowledging that a firm’s organizational form is a competitive choice, the analytical framework would appropriately encompass the factors that affect both the potential for competitive harm and the potential for efficiencies and other consumer benefits. For example, an analysis of the circumstances in which opportunism and free riding may occur would be very useful. Additional evidence that the parties were not able to agree on a contractual solution or that an existing contract did not work may be helpful in shedding light on the efficiencies of integration. Furthermore, market factors, including marketplace uncertainty, the amount of the fixed and sunk investments, the magnitude of firm-specific investments, and transaction costs may be important factors.
57. The ultimate focus of any analysis of vertical mergers should be on competitive outcomes, rather than the presence or absence of a particular kind of vertical arrangement. An empirical analysis of the efficiencies can maintain the focus on the net competitive outcome of the merger and should be pursued whenever possible.

## **VIII. Conclusion**

58. The vast majority of vertical mergers are motivated by efficiency considerations and many vertical merger transactions, do not result in a meaningful structural change in the marketplace. Market shares in the upstream and downstream markets, for instance, often do not increase as a direct result of the transaction. Thus, the focus of the analysis should be on the potential for efficiencies as well as the potential for the merged firm to extend any market power that it may have in the upstream or downstream market. BIAC submits that these potential effects should be evaluated in one comprehensive analysis. Moreover, given the

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Institute,” (April 18, 2005); and John Geweke, “Empirical Evidence on the Competitive Effects of Mergers in the Gasoline Industry,” University of Iowa Working Paper, (July 16, 2003).

<sup>19</sup> DG Enterprise and Industry, “Practical Methods to Assess Efficiency Gains in the Context of Article 81(3) of the EC Treaty,” Final report by Copenhagen Economics.

presumption of efficiency gains, a finding of negative effects requires a particularly careful factual analysis, as well as a clear articulation of the theory of harm. While there might be some value in vertical merger guidelines, the difficulties associated with the very nature of non-horizontal mergers, that various different forms they take and the current state of the economic literature, make such a task especially hard.