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DRAFT COMMISSION GUIDELINES ON THE ASSESSMENT OF NON-HORIZONTAL MERGERS

1. INTRODUCTION

In 2004 the EU Commission announced that it would issue guidelines regarding the treatment of vertical and conglomerate mergers. A first draft of these guidelines was published on 13 February 2007 and submitted for public consultation.

Vertical or conglomerate mergers contrast with horizontal mergers, since only the later may give rise to a significant impediment to effective competition by directly eliminating competition between the merging parties or by increasing the scope for collusion. Non-horizontal mergers are significantly less likely to produce negative economic effects, because those types of mergers do not entail a direct elimination of a competitor and are, moreover, often motivated by the desire to reduce costs or to achieve other (static or dynamic) efficiencies. BUSINESSEUROPE agrees that both vertical and conglomerate mergers should be dealt with through the same set of guidelines. We welcome the Commission's endeavours to explain how its analytical approach works for the various types of cases and to recognise explicitly the existence and relevance of efficiencies.

BUSINESSEUROPE considers that vertical and conglomerate mergers are of key importance for the integration of the internal market as they can boost companies' competitiveness by lowering their transaction costs through the integration of complementary activities and products within a single firm. Innovation may also be strengthened through the efficient allocation of resources and better coordination of the production process, thereby increasing economies of scale and allowing a company to become more pro-competitive. It is generally accepted that vertical mergers may give rise to the elimination of double marginalisation and may increase efficiencies in input choices and other static and dynamic efficiencies, therefore increasing consumer welfare by providing a better choice at attractive prices.

In this context, BUSINESSEUROPE supports the general approach taken by the Commission draft guidelines, but would like to express its views on some issues of key importance to European business.

2. BUSINESSEUROPE'S OVERALL ASSESSMENT OF VERTICAL AND CONGLOMERATE MERGERS

As already mentioned, vertical mergers can give rise to the elimination of double marginalisation and can increase efficiencies in input choices and other static and dynamic efficiencies, thereby increasing consumer welfare by providing a better choice at attractive prices.



BUSINESSEUROPE appreciates that in particular over the past few years economists have attempted to describe the precise circumstances under which vertical and conglomerate mergers may give rise to negative overall effects. Overall, the economic underpinning of anticompetitive foreclosure scenarios is, however, still developing. As a result, we believe that the Commission should be particularly cautious not to develop an over-inclusive enforcement policy in this important field. In this respect, we would take the view that -irrespective of the actual enforcement in individual cases- issuing enforcement guidelines in itself may affect business conduct.

BUSINESSEUROPE believes that a Commission policy in the field of vertical and conglomerate mergers must be based on two premises:

First, any analytical framework for the assessment of this type of merger should unambiguously explain the various theories of competitive harm on which prohibition decisions may be based and include rigorous standards of evidence which the Commission must meet if it wants to block a vertical or conglomerate merger or subject it to conditions. BUSINESSEUROPE considers that while vertical concentrations may exceptionally give rise to input or customer foreclosure, the analysis of each of those situations involves a number of steps with specific subtleties. Accordingly, we would welcome the guidelines explaining the precise circumstances under which each of these different types of situation may give rise to negative overall effects.

Second, BUSINESSEUROPE stresses that the future guidelines should more clearly take account of the efficiency-enhancing potential of this type of merger and set out a realistic and workable burden of proof required to establish these efficiencies. The rules governing the burden of proof, as well as the allocation of the burden of proof with regard to efficiencies should reflect the presumption that non-horizontal mergers in the vast majority of cases are welfare-increasing. Only in this way are the guidelines likely to meet the objectives of a transparent, efficiency-enhancing and well-balanced framework which is essential to the business community.

3. FORECLOSURE EFFECTS ANALYSIS

As mentioned in the guidelines, vertical mergers may in exceptional circumstances give rise to two types of foreclosure concerns. First, the situation of the new entity may be such that it no longer supplies rivals to its downstream entity or raises their costs by increasing its prices giving rise to upstream or input foreclosure. Such behaviour may result in the exclusion or "marginalisation" of downstream competitors. If it is established that this effect would result in a significant impediment to competition on the downstream market and harm consumers, the Commission could prohibit the transaction.

Conversely, downstream – or customer – foreclosure occurs where, following the merger, the downstream firm exclusively purchases inputs from the upstream divisions of the combined firms. As a result, upstream competitors may be confronted with higher costs or be excluded, in particular if the downstream firm accounts for a significant volume on the downstream market. This effect may be such as to significantly impede effective competition on the upstream market, when customer foreclosure prevents competitors from disciplining the behaviour of the merged entity, thereby allowing it to raise prices and hence harm consumers. Input and customer foreclosure may affect both actual and potential competition.



The draft guidelines define the concept of “foreclosure” too widely and this is a cause of concern to BUSINESSEUROPE. We consider that the Commission guidelines should clearly identify the grounds on which a vertical or conglomerate merger may be prohibited or be subject to conditions taking into consideration the foreclosure effects that may be observed. These effects should be significant before concluding that the non-horizontal merger significantly impedes effective competition. Thus, BUSINESSEUROPE would welcome a greater emphasis on the requirements to actually quantify the expected negative effects on consumer welfare. For example, we would expect the Commission to ascertain the long-term price rises that an anti-competitive foreclosure would bring about, rather than stopping short at the general observation that the merger in hand would bring about “anticompetitive foreclosure effects.” Similarly, BUSINESSEUROPE suggests that suggested price and non-price efficiencies are an integral part of the analysis from the start.

While it is sometimes suggested that vertical and conglomerate mergers may result in a number of (secondary) negative effects, such as the avoidance of regulatory constraints and price discrimination, BUSINESSEUROPE advocates that the guidelines should clearly establish that those effects are not in themselves sufficient for finding a significant impediment to effective competition.

BUSINESSEUROPE considers that in order for the guidelines to provide effective guidance, a more specific analysis of the incentives structure is necessary, over and above the statement that the Commission will assess whether the merged entity will have incentives to foreclose. We believe that for the guidelines to work as a practical tool, they should probe further into the structural and economic circumstances that would risk constituting a conflict with the merger regulation. We also believe that further explanation of the analysis methods is needed.

3.1 UPSTREAM OR INPUT FORECLOSURE

The assumption underlying the potential for upstream or input foreclosure is that it is more profitable and thus rational for the combined entity to stop supplying rivals to its downstream division or raise their costs than to continue to supply them. Accordingly, for a vertical merger to be prohibited for this reason it must be established that the combined firm will gain more in the future from foreclosing rivals than from currently supplying them under competitive conditions. BUSINESSEUROPE considers that it is of primary importance that the guidelines (i) appropriately identify the incentive and ability of the combined firm to exclude downstream rivals, (ii) require the Commission to predict with sufficient certainty the results of such behaviour on rivals and, more importantly, on competition, (iii) do not too readily accept that the effects of a foreclosure strategy are such that competition is significantly impeded and (iv) do not ignore or fail to take proper account of the countervailing effects of efficiencies.

Under input foreclosure theories, the existence of significant market power upstream is a necessary pre-condition. BUSINESSEUROPE stresses that the guidelines should take a cautious approach in this respect and should clearly articulate this position. Indeed, if the upstream market is sufficiently competitive, rivals are likely to undo the foreclosure strategy by expanding production or by resorting to other counter-strategies. The guidelines should preferably make clear that the Commission will in principle evaluate any type of counter-strategy. Thus, we expect the Commission to investigate why, in a specific case, counter-strategies are not feasible. Moreover, the



guidelines should establish beyond reasonable doubt that the only ground for prohibiting a vertical merger in this setting is a significant lessening of competition on the downstream market. In so doing, the guidelines should spell out that the Commission must establish that the combined firm already holds a significant position on the downstream market prior to the merger. Paragraph 43 should be made much clearer in this respect.

More generally, BUSINESSEUROPE considers that the guidelines on vertical and conglomerate mergers should set out that the Commission:

1. identifies the means by which the combined entity may foreclose on its rivals;
2. explains why, post-merger, the combined entity will have the *incentive* to foreclose on downstream rivals, i.e. explain why the company would, in the future, gain on a Net Present Value basis from exclusively supplying its downstream firm rather than also supplying its rivals. This requires a detailed analysis of the *profitability* of such a strategy. As a consequence, this analysis should include:
 - a. establishment of pre-merger upstream market power or dominance, sufficient to make the strategy profitable; if the Commission's theory of competitive harm is based on future dominance, the Commission must establish that there is a real likelihood of such dominance within the foreseeable future,
 - b. analysis of the viability of actual and potential upstream rivals, including matters such as capacity constraints, sufficient to show that the possible future foreclosure strategy is unlikely to be undone,
 - c. analysis of the links between upstream and downstream markets, in particular the proportions in which inputs are used and the magnitude of the costs of the inputs in relation to final products,
 - d. significance of the nature and intensity of competition on downstream markets and in particular the importance of buyer power and switching costs,
 - e. calculation of profits foregone as a result of a refusal to supply (or the loss of sales as a result of increased prices) and the calculation of the profits the merged entity will achieve as a result of being able to foreclose on its competitors in the downstream market;
3. explains the reasons why a foreclosure strategy is not only rational, but also practical and why the vertically integrated firm is able to commit itself to a post-merger pricing strategy that is consistent with foreclosure;
4. explains the absence of any counter-strategies available to (upstream) competitors to curb the combined entity's attempts to gain by significantly impeding competition on one or more downstream markets;
5. identifies the effects on downstream competitors and in particular a quantification of the standards by which downstream companies must be marginalised (rather than excluded altogether) within the meaning of paragraph 281, Case T-5/02 Tetra Laval v. Commission;



6. demonstrates and explain why the marginalisation of rivals results in a significant impediment to effective competition on one or more downstream markets;
7. quantifies the timeframe within which the effects of a foreclosure strategy must occur;
8. demonstrates that static and/or dynamic efficiencies are not sufficient to outweigh any identified negative results. It is preferable that the guidelines take account of the possibility that positive effects of the vertical merger materialise later or on other markets;
9. demonstrates that the effects are the result of the proposed merger, i.e. are merger-specific.

3.2 DOWNSTREAM OR CUSTOMER FORECLOSURE

By locking in downstream firms so that they are no longer accessible to upstream competitors, vertical mergers may result in a significant lessening of competition on the upstream market, when the customer foreclosure prevents competitors from disciplining the behaviour of the merged entity thereby allowing it to raise prices and hence harm consumers. As this effect is only likely if the downstream firm represents a significant proportion of the sales on the downstream market, BUSINESSEUROPE's view is that the guidelines should make clear that a sufficient degree of market power on that market is a precondition for finding that the merger significantly lessens competition. BUSINESSEUROPE submits that the present wording of the draft guidelines is too vague and, in particular, does not make clear when a customer is "important enough" for customer foreclosure to be a concern, and whether the notion of "important customer" implies that market power in the conventional meaning of the word is required. More generally, mergers which may give rise to downstream or customer foreclosure require an analysis similar to that which should apply for input foreclosure. The guidelines should establish that mergers giving rise to customer foreclosure may only be prohibited if they result in a significant lessening of competition on the upstream market. If the Commission believes that customer foreclosure may also lessen competition in the downstream market, it should also explain under what circumstances this might occur. In particular, the guidelines should set out that the Commission adequately identifies why the merger changes the incentive of the merged firm no longer to purchase from upstream rivals and why such a strategy is profitable.

4. OTHER NON-COORDINATED EFFECTS – FORECLOSURE OF POTENTIAL COMPETITORS

Vertical mergers may cut off potential competitors from access to inputs or customers. Such effects may increase the difficulty of entry and may, in exceptional cases, require firms seeking to enter one of the markets to enter both markets, thereby increasing the difficulty of entry and possibly significantly impeding competition.

Foreclosure of potential rivals should not in itself be sufficient to block a merger; only if the degree and nature of actual competition would be so low that a new entrant would exercise an important constraining influence on prices in the market should foreclosure of potential competitors be a concern.



In line with the points mentioned above, BUSINESSEUROPE advocates that the guidelines should set out that the Commission applies a rigorous analysis of barriers to entry, including an analysis of the sunk costs required to enter only one market and the timeframe within which entry is likely to be impeded.

5. CONGLOMERATE MERGERS

BUSINESSEUROPE considers that, while identifying how vertical mergers may squeeze out rivals is relatively straightforward, the analysis of conglomerate mergers requires a more sophisticated assessment of the precise means by which the combined firm may implement a profitable leveraging strategy.

According to the European Court of Justice, the analysis of conglomerate mergers is a prospective analysis in which, first, the consideration of a lengthy period of time in the future and, secondly, the conduct necessary to give rise to a significant impediment to effective competition mean that usually the chains of cause and effect are dimly discernible, uncertain and difficult to establish. The Commission should confirm this fact in the Notice on non-horizontal merger assessment to explain and signal that it is, in reality and for all practical purposes, quite difficult to demonstrate that conglomerate mergers lead to a significant impediment of effective competition.

In particular, the guidelines should concentrate on tying, technical tying, mixed bundling and explain for each practice the necessary conditions. The framework of analysis in the future guidelines should in particular be sufficiently clear on the required correlation between customer demands for the products at issue. Finally, the future guidelines should more fully incorporate the jurisprudence of the European Court of Justice with respect to the need to demonstrate that the harm to consumers will take place in the 'relatively near future' after the merger is implemented.

It is important that the guidelines make it clear that increased economies of scale, resources or, more generally, not well founded "portfolio" effects are in themselves insufficient for finding that a conglomerate merger significantly impedes effective competition. BUSINESSEUROPE is particularly concerned that the present language may suggest that the mere combination of several product portfolios may in itself give rise to concern. The guidelines should preferably make clear that foreclosure- or coordinated effects as a result of conglomerate mergers are only likely to occur in exceptional circumstances.

6. FINAL OBSERVATIONS

BUSINESSEUROPE urges the Commission to consider whether it would be possible to include a clearer positive policy-enforcement statement that non-horizontal mergers are potentially efficiency-enhancing. Indeed, the section dealing with efficiencies is brief and would benefit from a general policy statement that the Commission will generally not subject non-horizontal mergers to a detailed review. The sections on efficiencies may also be broadened to more explicitly include non-price and dynamic efficiencies and be modified to the effect that the requirements to establish efficiencies are tempered. Indeed, it would be reasonable to expect the parties to a merger to submit detailed efficiency calculations only if the Commission *prima facie* identifies serious anticompetitive concerns.



Second, BUSINESSEUROPE believes that the guidelines would be improved and would provide clearer guidance if the Commission would make clearer which theories of harm it believes are more likely to occur than others. In particular, it would be reasonable to add qualitative language that makes clear that conglomerate theories of harm only very exceptionally apply and that coordinated effects as a result of those types of mergers, or vertical mergers are equally unlikely.

Third, the draft guidelines contain numerous possible exceptions to observations that BUSINESSEUROPE considers valid and, moreover, take an overly cautious approach. This methodology could seriously undermine the practical value of the future guidelines. For instance, the safe harbour provision of paragraph 25 is, in BUSINESSEUROPE's view, not only too narrow, but also contains qualifying language that makes it clear that the safe harbour may not apply under certain circumstances, even if the relevant market shares are below the suggested level of 30%. BUSINESSEUROPE suggests lifting the threshold of the safe harbour to a significantly higher level, to make clear that the safe harbour may not apply to situations where coordinated effects are very likely and to make clear that, generally, anticompetitive foreclosure requires significant market power. That section should preferably also be modified to make clearer which relevant markets must be considered in the various settings.

7. CONCLUSIONS

BUSINESSEUROPE supports the Commission's commitment to providing clear and predictable guidance for businesses. We are especially pleased that the draft guidelines explicitly recognise the existence and relevance of efficiencies that are specific to non-horizontal mergers. We therefore believe that the Commission should more clearly articulate that non-horizontal mergers will only significantly impede effective competition in exceptional circumstances.

However, we consider that the draft is too vague, or even silent, regarding the circumstances under which an intervention by the Commission will be triggered with a view to securing commitments or to blocking the merger altogether. BUSINESSEUROPE fears that this reduces considerably the value of the draft as guidance, as described above, and hopes that the Commission finds these comments useful to take into consideration when putting forward the final guidelines on the assessment of non-horizontal mergers.

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