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Comments on the Draft Commission Guidelines on the assessment of non-horizontal mergers

1 Introduction

The EC Directorate General for Competition has issued draft guidelines on non-horizontal mergers (hereafter: the Guidelines) for the purpose of public consultation. The CPB Netherlands Bureau for Economic Policy Analysis, sector Regulation and Competition, greatly appreciates this opportunity to provide comments. In line with our expertise, we approach the problem from an economic perspective. A disclaimer applies that these comments do not involve the whole array of topics addressed in the Guidelines.

In contrast to horizontal mergers, a thorough understanding of possible anti-competitive effects of non-horizontal mergers has only evolved recently in reaction to the Chicago critique. It requires game theoretical models, which are complex and sensitive to underlying assumptions. In particular, whereas in the case of horizontal mergers a presumption of anti-competitive effects is warranted, for non-horizontal mergers this is not necessarily the case.

The Guidelines aim to incorporate the insights from recent economic thinking into a workable framework for the assessment of non-horizontal mergers. They discuss potential competitive harm arising from foreclosure, coordinated effects and conglomerate mergers. We will focus our comments primarily on the issue of foreclosure.

We have identified four broad issues we would like to comment upon. First, an important remark concerns the benchmark used in assessing the effects of vertical mergers. Many of the harmful effects from vertical integration can also be achieved by other means that do not require vertical integration (and the same may be true for pro-competitive effects). Second, the Guidelines focus on several sources of static efficiency, but hardly touch upon dynamic effects, leading to dynamic efficiency gains. Third, the commission's framework is largely based on

economic theoretical literature. We would like to emphasize the results found in empirical literature on harmful effects due to vertical integration. Finally, vertical mergers generally have pro-competitive effects as well as anti-competitive effects. Guidance on how to assess the relative strength of these effects should have a prominent role in the guidelines.

2 What benchmark to use

The objective of merger analysis is to analyze the prospective effects of a merger, compared to a situation in which such a merger does not take place. This implies that apart from the merger itself, also the counterfactual, no merger, requires analysis. In particular, one has to demonstrate that absent a merger, the anti-competitive foreclosure effects will not occur. Since the analysis in the consultation document focuses (rightly) on cases in which either the upstream or the downstream firm possesses some market power, it should be made clear why this dominant firm would not be able to fully exercise its market power without integrating. Stated differently, the analysis should be robust against the Chicago critique. The draft commission notice could explore this area somewhat more.

Integration could be argued to benefit the firm with market power if it can only extract its full oligopoly profits indirectly, through its (upstream or downstream) partner. It appears that this argument may be sensitive to the types of contracts that are available to the firms. At one extreme, if pure exclusionary contracts are available to the firms, one may argue that foreclosure will be feasible also to non-integrated firms, although such contracts might conflict with article 81 or 82. Even so, under general contracts, which might not be in conflict with article 81 (or 82), similar market outcomes may be realizable. Such contracts might involve for instance general (non-linear) price schedules and include fixed fees. With such contracts, it would also be easier to extract the full oligopoly profits from the non-integrated firm, without suffering from double marginalization. On the other hand, in situations where only linear price contracts (where only a single price is specified at which the downstream buyer may purchase any quantity of the upstream good) are feasible, integration might be a more efficient way of extracting such profits, avoiding the distortions of mark-ups in upstream prices.

It may be useful, then, to discuss the type of contracts in the intermediate market further, and elaborate on the possibility of two-part tariffs or more general clauses in specific industries. Clearly, in markets where retrading is common, and where possibly liquid markets exist (as would be the case for commodities such as energy), the scope for non-linear contracts is limited, whereas in say telecommunications or grocery products differentiated tariffs are quite common. (Note that in such industries, also the efficiency argument of elimination of double marginalization carries less weight).

Of course, even in the presence of general contracts, integration may serve a purpose of facilitating anti-competitive practices, such as when contracting externalities are present and integration helps the dominant firm to commit to foreclosing rivals by internalising this externality (as in Rey and Tirole, 2005; note that this argument does not hold in its simplest form for customer foreclosure). In the ‘raising rivals’ costs’ paradigm, integration could be necessary to justify relation-specific investments that may be required to commit to non-supply to rivals, where such investments would be likely to be held up without integration (note that this would be relevant in particular for non-contractible investments, so that a similar situation cannot be reached through regular contracts).

The point is that for such arguments for market power effects of vertical integration to be valid and persuasive, they would need more elaboration than currently in the document, in our view. The document would benefit from a clear description of the characteristics that a market should have for vertical integration to be a market power enhancing strategy.

3 Dynamic effects

As acknowledged in the Guidelines, there are strong arguments that non-horizontal mergers can be efficiency-improving. The Draft Guidelines focus on several sources of efficiency, but hardly touch upon dynamic effects, which could lead to dynamic efficiency gains.¹

In our view, such dynamic effects may be important. It is, therefore, desirable to discuss them explicitly. In particular, a vertical merger can be a strategic move of companies to optimize their production processes and capabilities to innovate. Even though this leads to higher rents of the merged firms and to the exit of (less efficient) firms from the market, the overall effect on consumer welfare can still be positive in the longer run. The economic literature includes theories supporting both a positive and a negative relationship between competition and innovation. In particular, the theory of the inverted U-shaped relationship as discussed in Aghion et al. (2005) may be relevant, which shows that innovative activities may be associated with some market power. To assess whether vertical integration is likely to enhance dynamic

¹Currently, dynamic issues are covered only briefly. Item 25a makes an exception with respect to the market share threshold for mergers that involve “a company that is likely to expand significantly in the near future, e.g. because of a recent innovation”; Item 55 states that on the positive side “a vertical merger may align the incentives w.r.t. investment in new products, new production processes and in the marketing of new products”; and Item 38 clarifies that the ability to engage in foreclosure is reduced when there is a possibility of effective counter-strategies of rival firms, such as changing the production process or sponsoring new entry.

efficiency in practice, one could look at the potential effects of such a merger on investments in R&D and on the adoption of new technology.

Another dynamic effect that should be taken into account is the potential response of competitors harmed by the merger. When a vertical merger is efficiency-improving, a wave of mergers may countervail anti-competitive effects of the initial merger (see e.g. Hart and Tirole, 1990).

4 Relation to the empirical evidence

We would like to emphasize that, besides economic theory, the empirical literature also provides analysis relating to vertical restraints which should be taken into account in the guidelines. Moreover, it is important to note that most of these studies are robust in verifying the pro-competitive nature of vertical mergers even in case of concentrated markets.

Lafontaine and Slade (2006) and Cooper et al. (2005) provide an extensive summary of the existing empirical literature on how vertical integration affects total. In many examples, industries concerned are relatively unconcentrated, and therefore less relevant for the guidelines. However, some of the studies reviewed in their papers are based on industries in which firms do have market power and therefore receive attention of competition authorities. These examples include for instance the cement and concrete industry, cable television programming and distribution, and oil refining and distribution. On the other hand, empirical evidence for highly concentrated industries is scarce and lessons should be taken with some caution in those cases.

Some of these collected empirical papers disclose evidence of foreclosure as a result of privately imposed vertical restraints. However, foreclosure is usually accompanied by lessened double marginalization or other efficiencies. Two of these papers assess the trade-off between these two effects and show that efficiency gains generally outweigh the welfare loss of foreclosure. Moreover, privately imposed vertical restraints in these instances always benefit consumers or at least do not harm them. They generally lead to lower costs, lower prices and greater consumption, and provide better chances of survival for the companies.

Other studies reverse the question and analyze the welfare effects of regulatory interventions in vertically related markets. They find that independently of whether mandated vertical restraints (compiled in Lafontaine and Slade (2005)) or mandated divorcement (Cooper et al. (2006)) are imposed, it systematically reduces consumer surplus or does not improve it.

Therefore, we would like to emphasize that the existing empirical evidence seems to support the claim that vertical integration occurs when participating parties find it beneficial and at the same time it increases consumer welfare and efficiency. Moreover, regulatory intervention may be detrimental to consumer welfare. However it should be noted that the empirical literature is not complete, since on the one hand it covers only a few concentrated industries, and on the other hand it is limited to the basic economic literature and does not include or separate the effect of either important market circumstances which may have facilitated foreclosure or whether effective counter-strategies of other participants have been present.

5 Guidance on how to measure relative strengths of pro- and anti-competitive effects

Economic theory and some empirical evidence show that vertical mergers can have pro-competitive effects. The general feeling among economists is that these effects are important. In addition, vertical mergers can have also anti-competitive effects. These effects generally arise through a change in supply or procurement strategy. Understanding the exact nature of these effects requires elaborate game theoretical modeling. There is no single model of competitive harm that applies to all circumstances. Whether there are anti-competitive effects and whether these effects might be outweighed by pro-competitive effects is highly case specific. Therefore, in case of a vertical merger no competitive harm can be presumed.

If a competition authority wants to block a vertical merger, it should address three central questions. First, what theory of harm could apply to this merger? On the basis of this theory, empirically identifiable market characteristics should be identified that can lead to foreclosure. The presence of these characteristics should be verified in practice. Second, what pro-competitive effects are present? The presence of these effects should be verified in practice. Third, how should pro-competitive effects be weighed against anti-competitive effects?

The guidelines are mainly concerned with (part of) the first question and discuss most theories of harm, though not all. They provide little guidance on necessary market characteristics, except for the identification of HHI ranges that provide a safe haven. We would recommend the use of other attributes to assess market outcomes expectedly leading to foreclosure, such as the pricing strategies available on the upstream market, the scope for non-contractible investments, economies of scale, entry barriers, cost efficiencies, switching costs; however our list is also not complete.

As for the second question, the guidelines only briefly discuss possible pro-competitive effects, besides overcoming double marginalization and increasing incentives to invest, for instance

protection against dealer opportunism and enabling pro-competitive price discriminating practices. This approach is justifiable from the viewpoint that a case should not be pursued in the first place if there is no clear theory of competitive harm that is applicable.

However, in our view identifying a possible theory of harm, although an important first step, is not the central problem facing a competition authority assessing a vertical merger. Rather, the central problem is to assess on the basis of empirical data first, whether the theory applies to a particular case and if so, the probability that the anti-competitive effects are outweighed by the pro-competitive effects. In our view, a systematic overview of necessary characteristics should be an important part of the guidelines that could aid this process. Also, where possible measurement issues should be discussed. In the case of customer foreclosure an inspiring example might be the discussion in Whinston (2006). Among other issues, he identifies a number of market characteristics that make this type of foreclosure more probable. These include scale effects, the consequences of asymmetrically sized buyers for contracts offered and the requirement expiration dates are spread out over time (staggered) if contracts have a limited duration. It is relatively easy to identify whether these market characteristics are present in specific cases.

6 References

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