

RBB Response to Draft Non-Horizontal Merger Guidelines

RBB Economics, May 2007

1 Overview

This paper provides comments on the draft guidelines on the assessment of non-horizontal mergers.¹ The publication of the draft guidelines is to be welcomed as representing a further step in Commission's endeavour to clarify and provide guidance on the application of economic principles to EC competition policy. The majority of the comments made in this document are designed to suggest changes that would clarify the approach set out in the draft guidelines rather than to suggest a radical change in that approach.

Our main points can be summarised as follows.

First, the definition of "foreclosure" proposed in the draft Guidelines is confused, unclear and ultimately misleading. The draft guidelines draw a distinction between "foreclosure" and "anticompetitive foreclosure". Only the latter provides a basis for competition concern. However, even within the draft guidelines themselves the distinction is confused. At some points in the draft, "foreclosure" appears to be defined as anything which restricts access to supplies or to customers which subsequently gives rise to price increases and elsewhere it appears to be defined as simply anything that makes competitors' lives more difficult.

If the intended definition of "foreclosure" accords with the former interpretation, then it is unclear what differentiates "foreclosure" from "anticompetitive foreclosure". If the definition of "foreclosure" instead accords with the latter, then at the very least more definitional precision is required if the proposed distinction between "foreclosure" and "anticompetitive foreclosure" is not to introduce an extremely low and unjustified hurdle to concluding that harm to competitors translates into harm to competition. More importantly, such a low hurdle would be at odds with the accepted view, reiterated in the draft guidelines themselves, that non-horizontal mergers generally do not give rise to competition concerns. The potential for confusion is of particular concern given statements in the guidelines as to the impact on rivals' revenue streams and the

¹ Draft Commission Notice. Guidelines on the assessment of non-horizontal mergers under the Council Regulation on the control of concentrations between undertakings.

alleged consequence adverse effects for competition.² We believe that the term foreclosure should be confined to the situation where significant anti-competitive effects have been identified.

Foreclosure, as defined in the draft guidelines is only a necessary but not a sufficient condition for a non-horizontal merger to give rise to genuine competition concerns. What is important is whether, as a result of that loss of access, rivals that currently exert an important competitive constraint on one or more of the merging parties are rendered significantly less able to compete effectively (ie competitors are marginalised) and as a result competition itself becomes less effective.

This means that the loss of access to a particular source of supplies or to specific customers is not sufficient to conclude that a given firm is likely to be marginalised. Indeed, in the majority of instances, rival firms are able to compete as effectively post-merger as pre-merger, and will be incentivised to compete even more vigorously with a more efficient merged entity. However, even if a particular firm or firms were marginalised by a non-horizontal merger, this need not translate to a weakening of competitive constraints generally. In short, to establish “anticompetitive foreclosure” (i.e. harm to competition) it is insufficient to establish harm to competitors.³

We would therefore propose to remove the distinction between “foreclosure” and “anticompetitive foreclosure” and instead reserve the term foreclosure for conduct that results in anticompetitive outcomes for consumers.

Second, we consider the 3 step approach proposed in the draft guidelines should represent sequential steps in the competitive assessment. The draft guidelines provide for a three step approach to assessing competition; these are essentially *ability*, *incentive* and *impact*. However, the interpretation of “foreclosure” that is adopted in the draft guidelines essentially implies that these steps are “intertwined”. In our view, the three steps can be seen as distinct stages in the analysis once a clear distinction is drawn between “foreclosure” and “anticompetitive foreclosure”.⁴

We consider that the first step, ability, should be revised to include a substantive screen for significant market power i.e. does one or both of the merging parties enjoy significant market power in a relevant market? It is commonly accepted that where firms do not possess significant market power, their actions cannot give rise to anti-competitive outcomes. To pass through this first filter, a non-horizontal merger must be shown to be capable of leading to anti-competitive effects. In the context of conglomerate mergers, for example, the ability step would also need to consider whether alleged post-merger practices (eg bundling) are possible.

The second step then relates to incentives. With respect to vertical mergers, a price increase to downstream customers, for example, is costly since those customers will purchase fewer units

² See *inter alia* paragraph 64.

³ As the Court of First Instance has noted, such theories require clear and convincing evidence.

⁴ We acknowledge that there may be some blurring as to which specific issues are assessed at each step. However, in terms of structuring the practical competitive assessment we consider it helpful to adopt a sequential approach.

from the vertically-integrated firm. The consequence of this loss of sales may more than offset the benefits to the merging parties of the price increase. In general, it is likely that the costs will exceed the benefits if the merged entity has only a small presence in the market (upstream or downstream) in which foreclosure is alleged to be taking place. In conglomerate mergers, the incentive step is better interpreted as “what incentives does the merger change”? Although a conglomerate merger may bring together complementary products this does not necessarily imply that the merged firm will have increased incentives to engage in bundling (see below).

The third step would then consider the impact on competition assuming the ability and the incentive to engage in the business conduct that gives rise to potential concerns.

Third, the draft guidelines should give more emphasis to the acknowledged efficiencies/pro-competitive benefits of non-horizontal mergers. Although the draft guidelines acknowledge the substantial scope for non-horizontal mergers to give rise to efficiencies,⁵ the more detailed discussion of such efficiencies is relegated to after a discussion of the possible anticompetitive concerns. In our view, the guidelines would be a more balanced document and be more reflective of the likely competitive concerns raised by non-horizontal mergers if the respective sections on vertical and conglomerate mergers started with a discussion of how such mergers can give rise to efficiencies.⁶

This would make it clear that any anticompetitive concerns arise *indirectly* via the marginalisation of competitors which is in marked contrast to competition concerns arising from horizontal mergers which arise *directly* via the potential elimination of one or more competitors. Acknowledging this would help re-emphasise a critical point in the competition assessment of non-horizontal mergers; namely, in proving that such indirect effects actually result in harm to competition, it is insufficient to establish harm to competitors.⁷ It is important to stress that there ought to be a presumption in favour of efficiencies generated by non-horizontal mergers; any efficiencies are held to be pro-competitive unless proved otherwise.

Moreover, applying the two-step approach to appraising anti-competitive and efficiency implications used in the assessment of horizontal mergers is inappropriate for non-horizontal mergers.⁸ First, given the acknowledged wide scope for non-horizontal mergers to create efficiencies, those efficiencies should be assessed up front and not as an afterthought. Second, in many instances, it is simply not possible to separate the assessment of competitive harm and the assessment of efficiencies. For example, the standard theories of harm raised by conglomerate mergers usually involve a short-run competitive advantage to the merging parties (often in the form of an ability to offer lower prices) which is alleged to result in the marginalisation of competitors and subsequently to the long run detriment of competition. But clearly, the short run price reduction also represents an efficiency that directly benefits consumers. In other words, the source of the potential competitive harm in this case is the same as the efficiency. We simply do not see how the two effects can be assessed separately.

⁵ See paragraph 13 *et seq.*

⁶ The Efficiency-Enhancing Effects of Non-Horizontal Mergers, RBB Economics, DG Enterprise, 2005

⁷ As the Court of First Instance has noted (see *inter alia Tetra Laval/Sidel*), such theories require clear and convincing evidence.

⁸ In the two-step approach, efficiencies are only considered to see whether they offset any competition concerns.

Fourth, the draft guidelines propose excessively cautious market share thresholds. The purpose of providing market share thresholds is (or should be) to provide a clear one-tailed test; if neither of the merging parties has a market share in excess of the threshold then all competition concerns can be readily dismissed without the need for detailed investigations. Given the acknowledgement that non-horizontal mergers do not generally give rise to competition concerns, the combined threshold of 30 per cent market share and where the HHI is below 2000 is set too low. Indeed, given the fact that significant market power has rarely been established below 40 per cent, a higher market share threshold than 30 per cent is appropriate. We would also propose dropping the HHI test since this is less relevant to assessing the likely competitive effects of a non-horizontal merger.

In setting the safe harbour threshold, explicit account needs to be given to the likely impact on enforcement. Setting the threshold too “low” provides an open invitation for speculative complaints from competitors who fear the pro-competitive consequences of a non-horizontal merger. There are obvious and serious costs if this were to occur, including the prospect that benign mergers are prohibited, or become caught up in such a high degree of regulatory uncertainty that they are discouraged altogether. In contrast, setting the threshold too “high” carries fewer risks.

While it may be the case that there is some increased probability that an anticompetitive horizontal merger might escape scrutiny, that risk is low given that most non-horizontal mergers do not raise any competition concerns. In effect, the draft guidelines should adopt a bolder approach in restricting the number of cases in which complaints can be made by broadening the safe harbour. By doing so, the draft guidelines would provide a clear green light to numerous pro-competitive mergers that would otherwise risk being snagged down in lengthy and costly detailed investigations that would take place under the current proposals. It would be incorrect for the Commission to produce guidelines that took no account of the costs of “false convictions”.

Fifth, we would amend the third step that assesses competitive impact by setting out more clearly when a non-horizontal merger will give rise to “anticompetitive foreclosure”. As noted above, we consider that the three step approach to assessing competition (*ability, incentive and impact*) is best seen as representing sequential steps in the competitive assessment.

The third step, impact, in our view should involve the following sub-steps each of which would need to hold in order to conclude that the non-horizontal merger would likely lead to anti-competitive effects through exclusionary effects.⁹ Since it is acknowledged that non-horizontal mergers do not generally give rise to competition concerns, it is important to provide appropriately high hurdles before concluding that harm to competitors translates into harm to competition i.e. foreclosure that results in higher prices to consumers needs to be proven and

⁹ It is also possible that non-horizontal mergers can give rise to coordinated effects (see Nocke and White, 2003, and Church, 2004). This assessment is equivalent to the assessment of coordinated effects under horizontal mergers. Further, some theoretical papers essentially based on static models suggest that non-horizontal mergers may result in softened competition. Such theories are highly sensitive to underlying assumptions and should not provide the basis for policy intervention.

not assumed to follow from showing harm to one or more competitors. The conditions required for non-horizontal mergers to harm competition through foreclosure are as follows.^{10 11}

- **Condition A: As a result of the merger, competing suppliers will lose volumes to the merged party and as a result are marginalised.** It is important to be clear as to what is meant by the marginalisation of competitors. For example, where a non-horizontal merger causes the merged entity to reduce its prices, this will adversely affect competitors in the sense that they will find it harder to make sales at the margins that prevailed prior to the price reduction. But, as noted above, that doesn't mean that competitors are always marginalised; indeed, price reductions are almost always to be welcomed as pro-competitive. A price reduction can be said to marginalise competitors only if, at any given price level, the competitive constraint provided by rivals were to be reduced following that (temporary) reduction. Similarly, the loss of access to supplies or customers will only marginalise a competitor if it adversely affects pricing decisions, by, for example, leading to an increase in short run marginal costs.
- **Condition B: Rival suppliers to the merging parties will find it unattractive or impractical to respond by adopting a similar strategy (or "counter strategy") that reduces the impact of the merged party's actions.** By merging with other firms or by arriving at equivalent contractual arrangements (so-called "teaming arrangements"), the rival suppliers may be able to deploy strategies that diminish or eliminate the competitive advantages of the hypothesized strategy (e.g. bundling or raising rivals' costs). Where such responses to the merged firm's hypothesized strategy are plausible the competitive concern will be to a large extent mitigated.
- **Condition C: As a result of the above chain of events, a sufficient number of competitors are marginalised so that competition and consumers are likely to be adversely affected in the long run.** In consequence, prices will increase and customer interests will be harmed. This can only occur if those competitors are marginalised to such an extent so as to significantly affect short run marginal costs or be forced to withdraw permanently from the market.¹²

The remainder of this paper is organised as follows. Section 2 provides a more detailed discussion of general issues arising from the assessment of non-horizontal mergers. We focus on the efficiencies created by non-horizontal mergers and discuss the concept of foreclosure. As noted above, by seeking to distinguish between "foreclosure" and "anticompetitive foreclosure" the draft guidelines are confusing and in places internally inconsistent. Moreover, this distinction raises a danger that harm to competitors will too easily be translated into harm to consumers. We also discuss the appropriate market share threshold.

¹⁰ These conditions focus on the foreclosure of *existing* competitors. Analogous conditions can be derived for strategies aimed at excluding potential entrants.

¹¹ These reflect, in addition to a significant market power screen, the same conditions proposed by RBB and accepted by the Commission during the investigation of *GE/Amersham*.

¹² Although in theory, competition could also be harmed if it could be shown that marginalisation had the effect of permanently reducing investment in new products. This is likely to be extremely difficult to prove in practice.

Sections 3 and 4 provide comments on specific paragraphs relating to the assessment of vertical and conglomerate mergers respectively. Section 5 outlines a proposed framework for assessing the competitive effects of non-horizontal mergers which revises that set out in the draft guidelines.

2 General comments

2.1 Background

There are important differences in the competitive assessment of horizontal and non-horizontal mergers. Horizontal mergers bring together manufacturers of substitute products, and so remove a direct competitive constraint. Whether the removal of this pricing constraint then leads to a price increase requires a detailed assessment.¹³ But even to the extent that the removal of this direct competitive constraint would tend, all else equal, to lead to an increase in price, this may be offset by counterbalancing efficiencies so that the price might fall below the pre-merger level. A two-step assessment that first considers the potential anticompetitive effects and then, if there are such effects, considers potential off-setting efficiencies represents a sensible approach.¹⁴

In contrast, non-horizontal mergers bring together suppliers of complementary (or unrelated) products, and so do not directly eliminate competition. Indeed, there is generally an incentive for the merged firm to lower its own prices. This is because, in a complementary relationship, a reduction in the price of one good will increase demand for the other. For example, a decrease in a distributor's margin would increase the sales of a manufacturer's product. Similarly, a decrease in the price of computer printers, for example, may increase the sales of complementary products such as ink cartridges and specialised paper. If firms are under separate ownership the beneficial impact of a price decrease (or quality improvement) on the other party's sales will not be taken into account. However, if the two parties merge, consideration of such effects will be internalised and would provide an additional incentive to lower price.¹⁵ The effect is usually pro-competitive and in line with consumer interests.

Non-horizontal mergers can cause anti-competitive effects only if such lower prices charged by the merging parties could result in the exclusion or marginalisation of competitors, or else if the merger causes the merging parties to worsen the terms on which competitors can gain access to inputs or customers (vertical mergers) or the terms on which combinations of their own products and those of rivals are made available to customers (conglomerate mergers).

Although price reductions brought about by non-horizontal mergers are usually pro-competitive, they may, under certain particular circumstances, give rise to anti-competitive outcomes. The primary competitive concern in these cases often relies on the assumption that, post merger, the ability of rival firms to compete will be reduced to such an extent that they are marginalised or driven from the market altogether. If this applies, the merged firm may be able to increase prices.¹⁶ But it is important to recognise when assessing possible anticompetitive concerns that

¹³ We do not subscribe to the view that all horizontal mergers necessarily give rise to an increase in price. Such predictions are posited on simple theoretical models which, although providing a useful analytical framework, do not provide a suitable basis for making real-world policy predictions.

¹⁴ Albeit in practice, the assessment of efficiencies rarely if ever overturns a finding that a horizontal merger removes a significant competitive constraint.

¹⁵ In economics parlance, the pricing externality is internalised.

¹⁶ Alternatively, entry or expansion may be deterred, allowing the firm to preserve its market power.

short-run effects that harm competitors can also bring direct benefits to consumers. The analysis of potential anti-competitive effects must therefore carefully specify the conditions that give rise to the purported outcome, and must go beyond a mere theoretical assessment by accounting for observed industry characteristics and behaviour.

2.2 The definition of foreclosure is confused, unclear and potentially harmful

Our main concern with regard to the assessment framework set out in the draft Guidelines relates to the use of the term “foreclosure” and the distinction that the draft guidelines seeks to draw between “foreclosure” and “anticompetitive foreclosure”.

The draft guidelines are right to emphasise that it is the threat of foreclosure that is the main cause for concern with respect to non-horizontal mergers. In this context, the three-step assessment framework presented in the draft guidelines that considers (i) the ability to foreclose, (ii) the incentive to foreclose, and (iii) the impact on effective competition is sensible. However, in making a distinction between “foreclosure” and “anticompetitive foreclosure”, and in the way that distinction is made, the draft guidelines at best create confusion and at worst risk promoting a fundamentally inappropriate standard for judging the effects of non-horizontal mergers.

“Foreclosure” is defined in the draft guidelines as “*any instance where actual or potential rivals’ access to supplies or markets is hampered or eliminated as a result of the merger, **thereby reducing these companies’ ability and/or incentive to compete***” (emphasis added).¹⁷ One can draw one of two implications from this definition. Either one places weight on “thereby reducing these companies’ ability and/or incentive to compete” in which case there is little difference between “foreclosure” and “anticompetitive foreclosure” or one place weight on “any instance where actual or potential rivals’ access to supplies or markets is hampered or eliminated as a result of the merger” in which case the term “foreclosure” would appear to encompass all situations where any competitor’s access to supplies or markets is disadvantaged regardless on the actual impact on consumers. Indeed, according to this definition of foreclosure one could consider that virtually all vertical and many conglomerate mergers give rise to “foreclosure”. The natural corollary of this position would be a general presumption against unilateral price reductions by firms on the grounds that such price reductions generally harm the commercial interests of rivals. That would clearly not constitute good policy.

Moreover, the definition of “foreclosure” proposed in the draft guidelines would appear also to include situations where rivals are disadvantaged simply as a result of the merged entity becoming more efficient. For example, a conglomerate merger may enable the merged entity to offer consumers a more attractive offering in the form of a bundle and thereby lead some customers to divert sales away from rivals, even if the prices of stand-alone products are unaffected. Such behaviour does not warrant being labelled as “foreclosure”.

¹⁷ Paragraph 18.

Furthermore, the important step from “foreclosure” to “anticompetitive foreclosure” is left alarmingly unexplained in the draft guidelines. The definition of “foreclosure” put forward in the draft guidelines, which focuses on the prospects of individual competitors, is inappropriate. Indeed, it runs contrary to the welcome statement at paragraph 16 in the Guidelines that “[i]t is the impact on effective competition that matters, not the mere impact on competitors at some level of the supply chain”. The relevant notion of foreclosure must relate to the potential for an entire market to be foreclosed to competition. While the assessment of such foreclosure might naturally include consideration of the impact of the non-horizontal merger on individual firms, such individual firm considerations have no relevance individually and would only inform the market-wide assessment.

The Commission appears to recognise in its draft guidelines that its definition of “foreclosure” captures a wide range of behaviour, much of which would not give rise to anticompetitive outcomes, by introducing the additional concept of “anticompetitive foreclosure”. This definition apparently encompasses those instances of “foreclosure” which may result in a (profitable) increase in the prices charged to consumers.¹⁸ But it is unclear to us what useful purpose is served by these two separate definitions of “foreclosure”. On the contrary, there is a grave risk that the term could give rise to an effective presumption that a non-horizontal merger is anti-competitive whenever “foreclosure”, as defined, arises. For example, in describing the potential for longer-term adverse effect at footnote 39, the Guidelines state that “[w]here prices are not likely to increase in the short run, foreclosed rivals may still lose significant sales to the merged entity. As a result of lower revenue streams, foreclosed rivals may be restricted in their ability to invest so as to further compete downstream, to the detriment of consumers in the future”. This suggests that once a proposed non-horizontal merger fulfils the Commission’s broad definition of foreclosure, speculative concerns may be sufficient to generate a prohibition decision.

The burden of demonstrating that such “foreclosure” does not amount to “anticompetitive foreclosure” is then liable to be shifted inappropriately onto the merging parties. Such an approach would be wrong in any merger setting, but particularly in the context of non-horizontal mergers, where a presumption that pro-competitive effects are likely to arise should be maintained.

To avoid confusion, ambiguity and the risk of inappropriate interventions, we would therefore strongly recommend that the term *foreclosure* is reserved for behaviour that could be expected to result in harm to competition and consumers, and not simply to competitors.

2.3 The 3-step competitive assessment represent sequential steps in the analysis

The draft guidelines set out a three step analytical framework for assessing whether a non-horizontal merger gives rise to “foreclosure” and if so whether it also gives rise to “anticompetitive foreclosure”. The three steps involve an assessment as follows:

¹⁸ See paragraph 18 of the draft guidelines.

- whether the merged entity would have the ability to foreclosure;
- whether the merged entity would have the incentive to foreclosure and finally
- whether as a result of this ability and incentive, the anticompetitive effect of foreclosure would arise.

The draft guidelines view these three steps as being intertwined. However, we think that they would provide more practical guidance if they were to be viewed as sequential steps in the analysis. As noted above, we believe that the distinction between “foreclosure” and “anticompetitive” foreclosure is blurred within the draft guidelines – foreclosure appears to be used to cover both “foreclosure” and “anticompetitive foreclosure” - and hence the three steps are necessarily “intertwined”. In our view, the three steps can be seen as quite separate, distinct steps in the analysis once a clear distinction is drawn between “foreclosure” and “anticompetitive foreclosure”.

We consider that the first step, ability, should be revised to include a significant market power screen i.e. does one or both of the merging parties enjoy significant market power in a relevant market. It is commonly accepted that where firms do not possess significant market power, their actions cannot give rise to anti-competitive outcomes. The ability step would also need to consider whether alleged post-merger practices are feasible. In the context of conglomerate mergers, for example, this would involve an assessment of whether bundling is even technically possible. The advantage of the sequential approach is that cases which fail this first screen can be dismissed at an early stage.

The second step then relates to incentives. In vertical mergers, a price increase to downstream customers, for example, involves a cost since those customers will purchase less from the vertically integrated firm as a result. Such costs may more than offset the benefits of the price increase.¹⁹ In general, it is likely that the costs will exceed the benefits if the merged entity has only a small presence in the market (upstream or downstream) in which foreclosure is alleged to be taking place. In conglomerate mergers, the incentive step is better interpreted as “what incentives does the merger change”? Although a conglomerate merger may bring together complementary products this does not necessarily imply that the merged firm will have increased incentives to engage in bundling.

The third step would then consider the impact on competition assuming the ability and the incentive to engage in the business conduct that gives rise to potential concerns. This step itself can be unpacked to involve a number of hurdles which must be overcome before harm to competitors can be used as a basis for a finding of harm to competition. These hurdles are discussed in Section 5.

¹⁹ Essentially, the incentive step is analogous to the (economic) requirement to show recoupment when assessing whether low prices constitute predatory behaviour.

2.4 The draft guidelines should give more prominence to the pro-competitive rationales for non-horizontal mergers

Section II of the draft guidelines usefully sets out the context in which non-horizontal mergers should be viewed from a competition perspective. It is recognised that such mergers:

- “are generally less likely to create competition concerns than horizontal mergers” (paragraph 11), notably because they do not remove a direct competitive constraint; and
- “provide **substantial** scope for efficiencies” (paragraph 13, emphasis added).

In short, there ought to be a presumption that combining complementary products leads to lower prices to the benefit of consumers. That presumption is the direct analogue of the inherent tendency for horizontal mergers (or more generally agreements between suppliers of substitutes) to give rise to a threat of increased prices.

However, though the draft guidelines recognise the substantial scope for non-horizontal mergers to give rise to efficiencies, the more detailed specific discussions of such efficiencies in the context of vertical mergers and conglomerate mergers are given apparently secondary weight, relegated below the discussions of possible anticompetitive concerns.

In our view the draft guidelines would offer a more balanced perspective and better reflect the likely competitive concerns raised by non-horizontal mergers if the respective sections on vertical and conglomerate mergers started with a discussion of how such mergers can give rise to efficiencies.²⁰ This would provide the appropriate background for the competitive assessment and usefully remind the user of the guidelines that any anticompetitive concerns arise *indirectly* via the marginalisation of competitors and often only after the direct effects have led to a price reduction. This is in marked contrast to competition concerns arising from horizontal mergers which arise *directly* via the potential elimination of one or more competitors. This would help re-emphasise a critical point in the competition assessment of non-horizontal mergers; namely, in proving that such indirect effects actually result to harm to competition it is not sufficient to establish harm to competitors.²¹

Moreover, applying the two-step approach used in the assessment of horizontal mergers is inappropriate for non-horizontal mergers,²² particularly in the case of conglomerate mergers. First, given the acknowledged wide scope for non-horizontal mergers to create efficiencies, those efficiencies should be assessed up front and not as an afterthought. Second, in many instances, it is simply not possible to separate the assessment of competitive harm and the assessment of efficiencies. For example, the standard theories of harm raised by conglomerate mergers usually involve a short-run competitive advantage to the merger parties (often in the form of an ability to offer lower prices) that is alleged to lead to competitors being able to compete less effectively and consequently to the long run detriment of competition. But clearly,

²⁰ See Chapters 3 and 4 of the RBB Report for DG Enterprise (reference at footnote 5).

²¹ As the Court of First Instance has noted, such theories require clear and convincing evidence.

²² In the two-step approach, efficiencies are only considered to see whether they offset any competition concerns.

the short run price reduction also represents an efficiency that directly benefits consumers. In other words, the source of the potential competitive harm is the same as the efficiency. We simply do not see how the two effects can be assessed separately nor how the assessment of the efficiency benefit can be somehow “bolted on” to the end of the analysis to offset any finding of a competitive harm.

2.5 The threshold for intervention should be raised

The draft guidelines note, in accordance with standard economics, that there can be no competition concerns if there is no market power in at least one market. In consequence, the draft guidelines usefully introduce a threshold below which intervention is unlikely. The draft guidelines state, at paragraph 25, that the Commission is “*unlikely to find concern in non-horizontal mergers ... where the market share post-merger of the new entity in each of the markets concerned is below [30%] and where the post-merger HHI is below [2000] except where special circumstances ... are present*”. The draft guidelines usefully state (paragraph 26) that market power is a necessary condition for competition concerns to arise and not a sufficient one; in other words, it cannot be presumed that competition concerns will arise if one or more of the merging parties breaches the above threshold.

We agree with this general approach i.e. it is useful to establish safe harbour thresholds. However, we believe the threshold is set too low in the draft guidelines.

Significantly, comparison with the horizontal merger guidelines suggests that the HHI threshold contemplated for non-horizontal mergers is actually tougher than for horizontal mergers. Specifically, horizontal mergers creating post-merger HHIs above 2000 fall below the relevant intervention threshold, provided the HHI increment is less than 150.²³ However, under the draft guidelines’ approach the threshold for non-horizontal mergers would be met whenever the HHI for any market affected would be above 2000, irrespective of the scale of the non-horizontal transaction being considered. Given the strong likelihood that the consequences of non-horizontal mergers will be substantially pro-competitive, this asymmetry is inappropriate.

Similarly, the Commission has indicated in its horizontal guidelines that horizontal mergers leading to a market share of no more than 25% can be presumed not to significantly impede effective competition. Again, given the generally pro-competitive nature of non-horizontal mergers and the adoption of a conservative 25% threshold for horizontal mergers, the 30% threshold proposed for non-horizontal mergers does not reflect the likelihood of adverse effects appropriately. Since in practice the Commission has rarely intervened against horizontal mergers creating shares below 40%, a threshold that was at least as high as this would be more appropriate for assessing generally pro-competitive non-horizontal mergers. Moreover, in view of the likely pro-competitive effects from non-horizontal mergers there are strong economic grounds for adopting an even higher intervention threshold.

²³ *Nota bene*, even this threshold is significantly below the level of concentration at which horizontal mergers are normally subject to serious challenge.

In setting the safe harbour threshold, explicit account needs to be given to the likely impact on enforcement. Setting the threshold too “low” provides an open invitation for speculative complaints from competitors who fear the pro-competitive consequences of a non-horizontal merger. There are obvious and serious costs if this were to occur, including the prospect that benign mergers are prohibited, or are subject to increased risks of regulatory scrutiny that could deter pro-competitive transactions.

In contrast, setting the threshold too “high” carries fewer risks. While it may be the case that there is some increased probability that an anticompetitive horizontal merger might escape scrutiny, that risk is low given that most non-horizontal mergers do not raise any competition concerns. Moreover, in many cases it would be open to use alternative competition law instruments – notably Article 82 – to regulate anti-competitive post-merger behaviour that emerged following the (unlikely) event of allowing an anti-competitive merger through. In effect, the draft guidelines should adopt a bolder approach in restricting the number of cases in which complaints can be made by broadening the safe harbour. By doing so, the draft guidelines would provide a clear green light to numerous pro-competitive mergers that would otherwise risk being snagged down in lengthy and costly detailed investigations that would take place under the current proposals. Any guidelines should take into account that the potential for over-enforcement imposes real costs on the economy.

3 Specific Comments on Vertical Mergers

3.1 General overview

3.1.1 Paragraph 27:

The draft guidelines state that “*pro-competitive effects stemming from efficiencies identified and substantiated by the parties*” will be taken into account. However, as noted in Section 2, this burden of substantiation is too high given the generally accepted view that vertical mergers give rise to many efficiencies. It is unclear how the parties could substantiate to the high standard set out in the horizontal merger guidelines whether, for example, a vertical merger was designed to overcome a perceived hold-up problem.

3.1.2 Paragraphs 28 and 57.

These paragraphs relate to “foreclosure”. Paragraph 28 states that “[f]oreclosure may discourage entry or expansion of rivals or encourage their exit”. Further: “it is sufficient that the rivals are disadvantaged and **consequently** led to compete less effectively. As a result of such foreclosure, the merging companies may be able to profitably increase the price charged to consumers”.

This appears to refer to “anticompetitive foreclosure” but that is not made clear in this paragraph. It therefore provides a stark example of the confusion that can arise in seeking to distinguish between “foreclosure” and “anticompetitive foreclosure”. The same issue arises in paragraph 57.

3.2 Paragraphs on ability

3.2.1 Paragraphs 35 to 36 and 60 to 63.

We agree with the statements made here subject to replacing “foreclosure” with “price”. If the hurdle to demonstrate ability only means a firm can engage in foreclosure in the very wide sense, then this will apply to any vertical merger and would therefore be an empty step in the analysis.

3.2.2 Paragraph 37

Although theoretically correct, the need to assess the reactions of rivals is in practice an empty or academic step. If it has been established that the merger will have the effect of foreclosing competition such as to lead to an elimination of effective competition and consequent harm to customers (e.g. in the form of higher prices) then the case for intervention against the merger is sound. A discussion of how rivals would respond to that price increase simply diverts time and attention away from the main issue.

3.2.3 Paragraphs 38 and 66

These paragraphs refer to the possibility of rival firms engaging in counterstrategies. This is an important part of the overall competitive analysis. However, we believe that this is better placed under *impact*.

3.3 Paragraphs on incentive

3.3.1 Paragraphs 39 to 42 and 67 to 69

With respect to input foreclosure, the main source of competition concern arises from the possibility that the vertically merged entity would be able to raise price or refuse to supply its downstream competitors. This section would be greatly clarified if instead of talking about “incentives to foreclose” we talked of “incentives to raise price”. Indeed, the following discussion is actually couched in such terms. This textual change would focus attention on what matters and remove the confusion between “foreclosure” and “anticompetitive foreclosure”.

Similar comments apply to the assessment of downstream foreclosure concerns, albeit that the incentives are to seek more favourable terms of supply from upstream suppliers or, more likely, to refuse to purchase from them entirely.

3.4 Paragraphs on impact

3.4.1 Paragraph 45

We agree with this statement. The same statement however applies equally to downstream foreclosure.

3.4.2 Paragraphs 46 and 71 to 72

A key element missing from paragraphs 46 and 71 is a discussion of when a firm is likely to become marginalised. Pricing decisions are made with respect to marginal costs and not average costs. Hence, a firm’s profitability could be reduced from a loss of sales but its ability to compete for such sales would be undiminished. It would be helpful for the guidelines to reflect this important point; in particular, to spell out in what circumstances a loss in sales translates into a loss of competitiveness. After all, the very essence of competition involves hurting competitors in terms of seeking to take sales away from them.

This point is particularly important in light of footnote 39 and paragraph 72. Here the draft guidelines worryingly open up the prospect that any loss of sales by a competitor can be seen as having long run adverse consequences for competition. Such statements need, at a minimum, to be highly qualified and to include appropriate hurdles before such arguments are accepted.

3.4.3 Paragraphs 47 and 74

It is important to note that the issue of preventing or hindering new entry can only ever give rise to competition concerns if either there is insufficient actual competition or it can be

demonstrated with convincing evidence that the new entrant would introduce lower priced or higher quality products.

3.4.4 Paragraphs 48 and 73

The draft guidelines state that if there remains sufficient competitors even if some rivals are marginalised then “*competition from those firms **may** constitute a sufficient constraint on the merged entity ...*”. Surely, it is the case that those firms **will** constitute a sufficient constraint? The same comments apply to paragraph 73.

3.4.5 Paragraphs 49 and 75

These paragraphs discuss the need to take into account countervailing factors such as buyer power and new entry. These would be better addressed either under ability (e.g. buyer power) or under incentives.

3.4.6 Paragraphs 50 to 56 and 76

Our comments on the treatment of efficiencies are provided in section 2 above.

3.5 Paragraphs on coordinated effects

These paragraphs provide little if any practical guidance as to how coordinated effects will be assessed in practice.

Paragraph 82 states that when a vertical merger leads to foreclosure it results in a reduction in the number of effective competitors in the market. However, it is unclear as to whether the term foreclosure is used in a wide sense i.e. some firms have lost access to a supplier or to customers, or in a narrow sense i.e. the vertical merger has result in increased prices to consumers. In the latter case, there would be little reason to assess whether there is an additional adverse effect; the anticompetitive foreclosure would itself provide grounds for objecting to the merger. If foreclosure is used in the wide sense, then it is not necessarily the case that the number of competitors is reduced. (Similar comments apply to paragraph 86.) Finally, the vague statement that “[g]enerally speaking, a reduction in the number of players makes it easier to coordinate among the remaining market players” does little to enhance the analytical rigour in this area. All horizontal mergers by definition involve a reduction in the number of active firms. However, by no means all horizontal mergers give rise to coordinated effects. This statement is therefore ultimately empty and should be removed.

Paragraph 83 discusses how an increase in symmetry between firms active in the market might increase the likelihood of tacit coordination. It would be useful for the draft guidelines to describe in more detail what types of symmetry make tacit coordination more likely.

Paragraph 87 notes that vertical mergers may improve the scope for ensuring adherence to any tacit understanding by increasing the scope for retaliation. However, vertical integration may also have the opposite effect by reducing or removing the scope for retaliation. It would be useful if the guidelines could indicate under which circumstances a vertical merger would increase or reduce the scope for retaliation. Indeed, as a general point, the draft guidelines only

look at potential adverse effects of merger in terms of coordination and not (destabilising) positive effects.

4 Specific comments on conglomerate mergers

4.1 General overview

4.1.1 Paragraphs 91 and 92

It would be useful for practical users of these guidelines to explain why, in the vast majority of cases, conglomerate mergers do not lead to competition concerns. This would provide the appropriate background to any detailed assessment that is undertaken under the steps proposed in paragraphs 92 et seq.

Similarly, in the discussion of potential competition concerns arising from conglomerate mergers it would be useful to practical users to outline how bundling or tying might lead to anticompetitive effects. In particular, this discussion would help highlight the fact that the practices of bundling and tying (as discussed in paragraphs 95 and 96) generally lead to lower prices to consumers, at least in the direct short run.

4.2 Paragraphs on ability

4.2.1 Paragraphs 94 and 97 to 99

As discussed in Section 2, the ability to engage in bundling or tying that might give rise to anticompetitive effects depends not only on at least one of the merging parties possessing significant market power but also on it being actually feasible to engage in bundling or tying. A necessary condition for a bundling or tying strategy to be feasible is that the products in question must be sold to the same customers and that purchases are either made at the same time (or that a credible temporal linkage can be made). These points are covered in part at paragraphs 97 to 99.

4.2.2 Paragraphs 100 to 103

We do not disagree with the content of these paragraphs but consider they are better placed under the heading of impact rather than ability.

4.3 Paragraphs on incentives

In addition to assessing the potential losses associated with pure bundling or tying strategies, it is also important to assess when considering the likely competitive effects of mixed bundling how the merger is likely to change a firm's pricing incentives post-merger.

Mixed bundling is more likely to occur if it represents a short-term profit maximising strategy for the post-merger firm. If this is not the case, then any mixed bundling strategy is essentially equivalent to a predatory strategy, whereby the post-merger firm is assumed to be willing to sacrifice profits in the short-term and recoup the losses in the longer term once the competitive process has been harmed. Such a theory of harm would need to explain why predation would

be profitable post-merger but not pre-merger and would also need to be assessed against the standards of assessing predatory behaviour under Article 82.

Pricing incentives can be altered if one of the following holds.

- There are significant Cournot effects arising from the merger i.e. there is very strong complementarity between two or more of the products affected by the merger so that a decrease in the price of one leads to a significant increase in demand for other products. Absent significant Cournot effects, the merged entity's pricing incentives would not materially change.
- Mixed bundling enables the merged entity greater scope for price discriminating across customers. This is most likely to be the case when firms do not set prices on an individual customer basis.

4.4 Paragraphs on impact

As is the case for the assessment of vertical mergers, a key element missing from paragraphs 109 to 111 which deal with the potential for anticompetitive effects is a discussion of when a rival firm is likely to become marginalised. As noted in the draft guidelines, competing firms may lose volumes to the merged entity following the implementation of a bundling or tying strategy. In principle, such a loss of volumes could lead to those rival firms being marginalised.

However, it is important to be clear as to what is meant by the marginalisation of competitors. Bundling and tying involve short run price reductions. But all price reductions will adversely affect competitors in the sense that they will find it harder to make sales at the margins that prevailed prior to the price reduction. But in general price decreases are not held to harm competition. A price reduction can be said to marginalise competitors only if at any given price level, the competitive constraint currently provided by rivals at that price level were to be reduced following a temporary price reduction. This can only occur if either competitors are forced to withdraw permanently existing products from the market or competitors cease to invest in the development of new products. It would be useful for the draft guidelines to be explicit on this point.

4.5 Paragraphs on coordinated effects

The discussion here provides little or no practical guidance. To the extent that coordinated effects represents a substantive issue at all, the potential for anticompetitive foreclosure will be present. Thus, in this case any concern under coordinated effects can be captured under unilateral effects. We therefore suggested deleting this section.

5 Suggested Policy Framework

As noted in Section 2, we broadly agree with the 3 step approach set out in the draft guidelines. However, we see these steps as representing sequential and not intertwined steps. In addition, we would propose giving more structure to the third and most important step, namely the impact of a non-horizontal merger on competition, by setting out the hurdles that need to be cumulatively overcome before a finding that harm to competitors gives rise to harm to competition.

Since it is acknowledged that non-horizontal mergers do not generally give rise to competition concerns, it is important to provide appropriately high hurdles before concluding that harm to competitors translates into harm to competition i.e. foreclosure that results in higher prices to consumers needs to be proven and not assumed to follow from showing harm to one or more competitors. The conditions required for non-horizontal mergers to harm competition through foreclosure are as follows:^{24 25}

- **Condition A: *As a result of the merger, competing suppliers will lose volumes to the merged party and as a result are marginalised.*** It is important to be clear as to what is meant by the marginalisation of competitors. For example, where a non-horizontal merger causes the merged entity to reduce its prices, this will adversely affect competitors in the sense that they will find it harder to make sales at the margins that prevailed prior to the price reduction. But, as noted above, that doesn't mean that competitors are always marginalised; indeed, price reductions are almost always to be welcomed as pro-competitive. A price reduction can be said to marginalise competitors only if, at any given price level, the competitive constraint provided by rivals were to be reduced following that (temporary) reduction. Similarly, the loss of access to supplies or customers will only marginalise a competitor if it adversely affects pricing decisions, by, for example, leading to an increase in short run marginal costs.
- **Condition B: *Rival suppliers to the merging parties will find it unattractive or impractical to respond by adopting a similar strategy (or "counter strategy") that reduces the impact of the merged party's actions.*** By merging with other firms or by arriving at equivalent contractual arrangements (so-called "teaming arrangements"), the rival suppliers may be able to deploy strategies that diminish or eliminate the competitive advantages of the hypothesized strategy (e.g. bundling or raising rivals' costs). Where such responses to the merged firm's hypothesized strategy are plausible the competitive concern will be to a large extent mitigated.
- **Condition C: *As a result of the above chain of events, a sufficient number of competitors are marginalised so that competition and consumers are likely to be adversely affected in the long run.*** In consequence, prices will increase and

²⁴ These conditions focus on the foreclosure of *existing* competitors. Analogous conditions can be derived for strategies aimed at excluding potential entrants.

²⁵ These reflect, in addition to a significant market power screen, the same conditions accepted by the Commission during the investigation of *GE/Amersham*.

customer interests will be harmed. This can only occur if those competitors are marginalised to such an extent so as to significantly affect short run marginal costs or be forced to withdraw permanently from the market.²⁶

²⁶ Although in theory, competition could also be harmed if it could be shown that marginalisation had the effect of permanently reducing investment in new products. This is likely to be extremely difficult to prove in practice.