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What can be expected from the Commission's non-horizontal merger guidelines?

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Abstract

Trois ans après la publication des lignes directrices de 2004 sur l'appréciation des concentrations horizontales, la Commission s'apprête à publier un projet de lignes directrices sur l'évaluation des concentrations non-horizontales. Ces derniers mois, par le biais de présentations, la Commission a dévoilé certains aspects de ce projet de lignes directrices et l'approche qui sera sans doute retenue. Cet article passe en revue la littérature économique traitant des fusions non-horizontales et évalue les changements que l'on peut attendre dans ce domaine sur la base des déclarations publiques récentes de la Commission.

Three years after the publication of the 2004 Horizontal Merger Guidelines, the Commission is expected to publish soon draft guidelines on the competitive assessment of non-horizontal mergers. The Commission's thinking has been unveiled over the last few months through presentations by DG Comp officials which provided insights into the main aspects of the forthcoming draft guidelines. This article discusses the economics of non-horizontal mergers and assesses the changes that can be expected based on recent public declarations by the Commission about the guidelines.

1. In the last five years, the Commission's analysis of non-horizontal mergers (NHM hereafter[1]) has been harshly criticized by the European Courts. In 2002, the CFI annulled the Tetra Laval / Sidel merger prohibition in which the Commission's theory of harm relied on anti-competitive conglomerate effects.[2] Then, in 2005, the CFI rejected the Commission's analysis of non-horizontal (vertical and conglomerate) effects in the GE/Honeywell prohibition decision[3] (the decision was upheld on the basis of "traditional" horizontal effects). Following these severe rebuttals, it was time for the Commission to reflect on the principles that should guide its analyses of NHM and a team within DG Comp has been working on the preparation of draft guidelines, expected to be published in the coming months. These guidelines should usefully complement the horizontal merger guidelines. However, due to the nature of the theories of harm in NHM, the new guidelines are likely to (and should) share common principles with the future Article 82 guidelines. The Commission has shared its thinking on NHM and presented the main features of the guidelines in recent presentations.[4] In this paper, we first review the evolution of economic thinking with regards to non-horizontal mergers and in light of the literature review, we discuss the direction that the Commission is (hopefully) expected to follow in the new draft guidelines.

I. Why are non-horizontal mergers different?

2. First of all, it is important to understand how NHM distinguish themselves from horizontal mergers. There are two main categories of NHM: (1) conglomerate mergers – where the merging firms operate in different relevant markets (the products produced by the merging firms can either be complements or independent[5]); and (2) vertical mergers – where the merging firms operate at different levels of a supply chain (e.g. an upstream manufacturer and a downstream distributor).[6]

1 We use the same acronym as the EAGCP (Economic Advisory Group for Competition Policy) in their paper posted on DG Comp's website: "Non-Horizontal Merger Guidelines: Ten Principles".

2 Case T-5/02, *Tetra Laval BV v Commission*, Judgment of the Court of First Instance of 25 October 2002. Note that CRA International acted as economic advisors to Tetra Laval during the merger investigation and the appeal procedure before the CFI.

3 Cases T-209/01 and T-210-01, *Honeywell v Commission* and *General Electric v Commission*, Judgments of the Court of First Instance of 14 December 2005. Note that CRA International acted as economic advisors to GE during the merger investigation and the appeal procedure before the CFI.

4 For a review of the economics of NHM, see the presentation by Miguel de la Mano from the Chief Economist Team of DG Comp at http://ec.europa.eu/comm/dgs/competition/delamano1.pdf (July 2006, Fordham Competition Law Institute, New York) and the presentation on the guidelines by Carles Esteva-Mosso at www.crai.com (5 December 2005, CRA conference).

5 Product A (e.g. cereals) and product B (e.g. milk) are complements if an increase in the price of A (cereals) leads to a *reduction* in the demand for product B (milk). In economic terms, this translates into the cross-price elasticity of complement products being negative (because of the negative relationship between the price of cereals and the demand for milk). For substitute products, the effect is opposite. An increase in the price of product A (e.g. water brand Volvic) will increase the demand for product B (e.g. water brand Spa). In this case, the cross-price elasticity is positive (if the price of Volvic goes up, part of the demand will switch to Spa). When products are independent, the cross-price elasticity is zero: changes in the price of product A (e.g. water) has no effect on the demand for product B (e.g. soap), all else equal.

6 In vertical mergers, the activities of the merging firms are "complementary" and therefore, as in the case of complement products, the increase in the price at one level of the supply chain (e.g. the production of luxury perfume) will have a negative effect for the demand of the other activity (e.g. the distribution of luxury perfume in selected outlets), and vice-versa.

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3. Because the nature of the products of the merging firms is fundamentally different between non-horizontal and horizontal mergers, this leads to an entirely different type of possible anti-competitive effects. A horizontal merger (i.e. the combination of producers of substitutes) removes a direct competitive constraint that affected the pricing of each party prior to the merger. This has the primary effect of *creating (or strengthening) market power* relative to the pre-merger situation, usually leading to higher prices. Of course, there are different ways in which market power can be enhanced (through unilateral or coordinated effects) and the *degree* to which additional market power can be exercised needs to be assessed (taking into consideration efficiencies generated by the combination of assets or any countervailing factors). With NHM, there is no such "market power creation" effect because the merging parties are *not* competitors in a relevant market.[7]

4. This is not to say that NHM cannot generate anti-competitive effects and harm consumers but the *mechanism* by which consumer welfare may be negatively affected is intrinsically different from horizontal mergers: any competitive harm arising from a NHM would tend to be caused by a *change in behaviour* on the part of the merging firms but generally, any competitive harm would only arise if there was market power prior to the merger. This observation leads to powerful screens for NHM: unless any of the merging firm possesses significant market power on one of the markets prior to the merger, there should be an *a priori* that anti-competitive effects are unlikely.

5. As can be anticipated, theories of harm for NHM and exclusionary conduct by dominant firms are closely linked. The difference between a NHM investigation and an Article 82 investigation lies in the additional hurdle that the Commission should identify how a merger will *create* the conditions for exclusionary conduct and evaluate the likelihood that the expected behaviour will be implemented. In an Article 82 investigation, the assessment focuses rather on whether the observed behaviour has (or has had) exclusionary effects.[8] The role of *ability* and *incentives* to engage in a given strategy should therefore constitute a crucial first step in analyzing NHM.

6. The ultimate test however (for both Article 82 and NHM investigations) should be to establish that the behaviour has foreclosure effects leading to consumer harm. To use the wording of the new merger regulation,[9] a "*significant impediment to effective competition*" in the context of NHM would emerge from the prospect of *foreclosure effects* that lead to higher prices or lower quality for consumers. While the exclusionary conduct directly affects competitors (by shifting market demand away from them or by degrading their access to necessary inputs), the main concern should be whether consumers ultimately suffer. This is the general approach advocated by the Article 82 Staff Discussion Paper (2005): "*By exclusionary abuses are meant behaviours by dominant firms which are likely to have a foreclosure effect on the market, i.e. which are likely to completely or partially deny profitable expansion in or access to a market to actual or potential competitors and which ultimately harm consumers*."[10]

7. With NHM, the competitive harm is therefore *indirect* and arises from a chain of events leading to higher prices or lower quality for consumers whereas in horizontal mergers the anticompetitive effects *directly* stem from the merging parties' incentives to rise prices (absent efficiencies) or from changes in the market structure allowing market participants to directly raise prices (through coordination). Before discussing the possible theories of harm in the context of NHM, it is however useful to take a step back and understand the economic drivers of vertical and conglomerate expansion (through merger).[11]

8. The nature of the products distinguishes the ways in which anti-competitive may arise in horizontal mergers and NHM and also explains the specific characteristics of "non-horizontal" efficiencies (as opposed to marginal cost savings usually expected in horizontal merger contexts). These are discussed in the next section.

II. The rationale for vertical and conglomerate mergers

1. Vertical Mergers: Do it in-house or outsource?

9. Vertical mergers raise questions about the boundaries of the firm: firms make decisions about the activities that are better handled in-house and those that are better handled using arm's length contracts. This is the primary question facing firms contemplating vertical integration and the answer to this question may vary across industries, across firms within an industry or over time (the car industry is a good example of successive waves of integration and disintegration or varying degrees of vertical integration across car manufacturers).

7 As we will see later, NHM can *enhance* or *enable* the exercise of existing market power.

8 In both the *Tetra Laval / Sidel* and *GE / Honeywell* judgments, the Courts made it clear that assessing the likelihood that the expected exclusionary behaviour *will be* implemented is a decisive stage in the analysis. The Courts indicated that the Commission should show "*with a sufficient degree of probability that the conduct in question will actually occur*" (see the *GE/Honeywell* Judgment, *op. cit.*).

9 Council Regulation (EC) No 139/2004 of 20 January 2004 on the control of concentrations between undertakings.

10 See paragraph 1 of the Article 82 Staff Discussion Paper, December 2005 We note however that in paragraph 58, the definition of foreclosure does not refer to the ultimate goal of preserving consumer welfare and has a language reminiscent of policies that primarily protect competitors: "*By foreclosure is meant that actual or potential competitors are completely or partially denied profitable access to a market*".

11 Both vertical integration and conglomerate integration can occur by merger or by internal growth (e.g. by building the necessary facilities and acquiring the necessary assets to produce a new product or undertake an upstream or downstream activity). A discussion of the factors leading to vertical integration can be found in a paper by Paul L. Joskow, Vertical Integration, 2 December 2003. Available at http://econ-www.mit.edu/faculty/

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10. There are several reasons why vertically related companies may choose to merge and combine their complementary assets rather than carry out their activities through contractual arrangements. These reasons are generally linked to the difficulty associated with writing and/or enforcing complete contracts[12] and the existence of transaction costs.[13] Vertical integration is in fact one solution to minimize transaction costs and avoid the risks associated with incomplete contracts. In particular, vertical integration can:

- Improve reactions to market evolutions by coordinating decisions;
- Improve investment incentives and reduce the risk of ex-post opportunism ;[14]
- Avoid the free rider problem affecting the "appropriate" level of effort and investments by downstream distributors.[15]

11. While horizontal mergers will generally give a direct incentive to the merging parties to raise price (or reduce output), vertical integration can bring direct incentives to *reduce* prices. This is typically called the "elimination of double marginalisation" (or "pricing efficiency"). Because the activities of vertically integrated firms are complementary, pricing decisions taken independently at each level of the supply chain can lead to prices that are "too high" at each level relative to what a single entity controlling the chain would charge (this is because each party fails to take into account the negative externality of its pricing decisions on the other levels of the chain[16]). By coordinating pricing decisions at the upstream and downstream levels, the negative externality is "internalised" (i.e. taken into account) and prices are expected to fall as a direct result. In fact, the circumstances in which the "pricing efficiency" effect is the strongest are when firms have significant market power upstream *and* downstream and price discrimination is not feasible (see next point).

12. While vertical integration may solve the problems facing independent decision making by firms engaged in complementary activities, it is not the sole solution. Indeed, non-linear pricing or vertical restraints constitute other alternatives to replicate the effects of vertical integration through contractual means.[17] Yet, vertical integration is often the most rapid and certain way to achieve those efficiencies. The fact that pro-competitive motives can generally explain vertical integration warrants a prudent approach from competition authorities when assessing such mergers.

2. Conglomerate Mergers: Bringing products together

13. Conglomerate mergers bring under common control products that are either complements (e.g. avionics and engines as in the GE / Honeywell case) or independent (e.g. carton packaging machines and PET-packaging machines as in the Tetra Laval / Sidel case[18]). Conglomerate mergers provide the opportunity to *produce* or *sell* products together (using bundling or tying strategies). Various types of efficiencies may explain the attraction, for the merging firms, of having the opportunity to combine certain products.

14. Conglomerate mergers also solve problems generated by transaction costs or incomplete contracts as in the case of vertical mergers. In particular, conglomerate mergers can generate two main types of efficiencies: economies of scope in consumption and economies of scope in production.[19] Other types of efficiencies include the diversification of activities (by entering new product markets, companies can reduce the risks associated with focusing on a given product and being dependent on specific market shocks affecting that product).

15. Economies of scope in consumption arise when the cost of purchasing two (or more) products is reduced for the consumer as a result of purchasing from a single source. This may arise through technical bundling (i.e. it is less costly to purchase a computer already incorporating all the necessary components

12 In a complete contract, the parties could specify their rights and obligations under *any* future situation.

13 Transaction costs are the costs of economic exchanges (i.e. obtaining information on market prices, writing and enforcing contracts).

14 Ex-post opportunism arises when one party has made specific investments to produce, say an input, for another party (e.g. an auto supplier developing a component for a given car model). These investments are only valuable in the context of the relationship between the parties. Once the investments have been made, the parties become "dependent" (the car manufacturer depends on the supplier for the part and the auto supplier depends on the sales of the component to the car manufacturer to recoup its investment). With the bargaining power that each party holds, there can be attempts to renegotiate the contract's conditions once the investment has been made and both parties are "locked-in" (e.g. the car manufacturer may threaten to considerably reduce the quantity purchased from the supplier without price concessions). This risk of "*ex-post*" opportunistic behaviour has the effect to reduce the (ex-ante) incentives to invest.

15 Some types of vertical restraints (such as exclusive territories or selective distribution) are put in place as a solution to free riding. Free riding occurs when a firm benefits (without paying for it) from the investments made by another firm. A typical example is that of a car dealer offering low-quality services and benefiting from the investments made by dealers providing high-quality pre-sale services. Once a customer has enjoyed the high-quality services to obtain information on the car, it can purchase the car at a lower price from the dealer with low-quality service. The free riding problem typically reduces the ex-ante incentives to invest in high-quality services and dealers end up investing than desired by the car manufacturer. When integrating downstream, the manufacturer can control directly the investments and effort levels of its owned distribution arm.

16 As indicated earlier, increasing the price at one level of the chain *negatively* affects demand at the other level of the chain and this effect is not taken into account when prices are set independently. Assuming some market power at the production and distribution level, the independent distributor charges a mark-up on a wholesale price that is already marked-up (i.e. both are above marginal cost). The "mark-up over mark-up" is the double marginalisation that a vertically integrated firm would not implement.

17 Pricing is non-linear when the unit price varies per quantity purchased. In the context of an upstream monopolist and a downstream monopolist for example, the upstream monopolist can achieve the same profit as under vertical integration by charging the downstream firm a wholesale price at marginal cost (i.e. no mark-up) plus a fee so as to extract the full monopoly profit.

18 In the *Tetra Laval / Sidel* case, the Commission accepted that carton and PET were used to package different types of liquids and were in separate markets. However, for some products (so-called "sensitive products" such as milk and juice due to their rapid degradation if exposed to light), the use of PET was expected to develop in the future and therefore, carton and PET might become substitutes in the future for these products.

19 Economies of *scope* arise when the average cost of production is reduced through joint production of different products (as opposed to economies of *scale* arising from the increase in the volumes of production of the same product).

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rather than purchasing each component from a different manufacturer)[20] or from the benefits of "one-stop shopping". Economies of scope in production arise when the production of the products (complementary or independent) share some common activities (e.g. a food company with R&D, marketing and distribution activities could achieve operational efficiencies by adding food products to its existing offering).

16. There are also pricing efficiencies associated with controlling the production of complements, called the "Cournot effect" (it is the equivalent of the elimination of double marginalization in the case of complements).[21] More generally, in the case of both complements and independent products, jointly selling (through bundling or tying) allows the firm to price discriminate and extract consumer surplus. Such price discrimination tends to be profit-maximising for the firm (even absent any exclusionary effects).[22]

17. The coordination of pricing decisions and other decisions (production, investment…) by entities that do not directly compete can therefore bring about significant efficiencies. Achieving such coordination is a primary driver for NHM suggesting that most NHM will be innocuous from a competition perspective. We now turn to the circumstances in which NHM can lead to anti-competitive effects and harm consumers.

III. The evolution of theories of foreclosure

18. Over the past fifty years, the economic theory has evolved considerably from "naïve" foreclosure theories in the 50s and 60s, to the overly permissive attitude of the Chicago school of thought in the 60s and 70s, back to the middle ground recent literature on exclusionary conducts based on models using game theory.[23] So where do we stand after all these years?

20 Note however that it is not necessary for the producers of the various components to be *integrated* for the benefit from technical bundling to the consumer to arise. Yet, the choice of producing in-house a set of complementary products raises the same questions as those discussed for vertical integration.

21 Under the "Cournot effect", a monopolist producing several complements would price the complements at a lower price than several monopolists each pricing one of the complements. This is due to the negative pricing externality between complements.

22 The price discrimination motive of bundling has been widely analyzed in the context of a monopolist. For independent products, the attractiveness of bundling arises from selling products to customers with negatively correlated preferences for the products: for example, sports fans have low valuations for movies and high valuation for sports (while it is the opposite for movie fans). A broadcaster offering a sports channel and a movie channel could increase its profits by offering an appropriately priced bundle including both channels. By selling the bundle of sports + movie channels at a price close to the total willingness to pay (for both channels) of each group of customers, the broadcaster could avoid the usual trade-off between high price and large sales and effectively extract surplus from both groups of consumers.

1. Chicago insights: The role of efficiencies and incentives

19. The so-called Chicago school of thought emerged after a spate of prohibitions of vertical mergers in the US in the 60s and 70s.[24] The Chicago school legacy can be divided into two main concepts: first, the notion of the "One Monopoly Profit" and second, the necessary focus on efficiencies when analyzing NHM.

20. The "One Monopoly Profit" theory formalizes the idea that a monopolist on one market will *not* (necessarily) have the incentive to leverage its market power to another market. In a situation where company X is a monopolist on market A and faces competition on market B, the argument goes that firm X is able to extract full monopoly profits on market A and there are no additional gains to be made from exercising market power on market B as well. In his study on bundling for the DTI[25], Nalebuff offers a useful illustration of the theory using the following example: product A (monopoly) is a ticket to the London Eye and product B (competitively supplied) is bottled water. A simplistic view could be that the London Eye would necessarily benefit from bundling its tickets with bottled water. The Chicago School has demonstrated that this need not be the case: if the London Eye ticket is sold at full monopoly price, the London Eye could not raise its profits by bundling the ticket with bottled water because it cannot sell the bundle at a price exceeding the (monopoly) London Eye ticket price plus the (competitive) bottled water price.[26] In other words, if a firm has monopoly power on one product, it can extract all the monopoly rents but it cannot achieve higher profits by leveraging market power on another market because there is only "One Monopoly Profit" to be earned.

21. Of course, the "One Monopoly Result" relies on specific assumptions (e.g. the products are sold in fixed proportions[27], the model has no dynamic effects…) and may not hold once these assumptions are relaxed. However, the main contribution of this theory has been to challenge the naïve view of foreclosure incentives and to demonstrate that there are cases in which there is no exclusionary benefit from leveraging market power from one market to another.

23 Michael Riordan offers a comprehensive review of the economic literature on vertical integration and recent US cases. "Competitive Effect of Vertical Integration", Columbia University, Mimeo, 2005. www.columbia.edu/

24 See the following famous cases where vertical mergers were prohibited: *United States v. E.I. du Pont de Nemours & Co*, 353 U.S. 586 (1957), *Brown Shoe Co. v. United States*, 370 U.S 294 (1962) and *Ford Motor Co. v. United States*, 370 U.S. 294 (1972).

25 Barry Nalebuff, Bundling, Tying, and Portfolio Effects, Part 1 – Conceptual Issues, DTI Economics Paper No1, February 2003 (page 20).

26 If it did so, it would actually lower its profits. At a combined London Eye ticket and bottled water price exceeding the monopoly ticket price and the competitive water price, the London Eye would in fact loose profitable sales of its monopoly product.

27 This assumption implies that the monopolist – by its pricing – can affect the quantities sold of the competitive product. Indeed, the price of the monopoly product will affect the quantities of the monopoly product but also (because the two products are sold in fixed proportions), the quantities of the competitive product.

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22. When there are no benefits from leveraging market power, the rationale for integration (vertical or conglomerate) is therefore likely to be pro-competitive and efficiency enhancing. The Chicago School of thought therefore shifted the focus on the efficiency drivers for non-horizontal mergers by demonstrating that foreclosure effects were not to be expected *a priori* in mergers between firms that are not direct competitors.

23. The focus on efficiency effects as a primary effect of vertical or conglomerate mergers (such as the double mark-up elimination) is another contribution of the Chicago School. As already discussed, post-merger prices may actually *fall* as a direct result of the coordination of pricing decisions by the two merging parties in NHM.

2. The rise of models with foreclosure effects

24. In the last two decades, economists have revisited the lenient approach advocated by the Chicago School and developed a range of models in which NHM could lead to exclusionary effects. These models can be divided into two main categories in the context of vertical mergers: (a) input or customer foreclosure (from outright refusal to supply or to purchase to other strategies to raise the costs of inputs to rivals); (b) facilitation of collusion. Theories of harm in the context of conglomerate mergers are generally associated with the literature on the exclusionary effects of bundling. These theories are reviewed in turn below.

3. Vertical foreclosure

25. Under its most extreme form, vertical foreclosure involves a complete refusal to supply non-integrated downstream firms or a refusal to purchase from non-integrated upstream firms. In the context of *input foreclosure*, an upstream firm could decide that post-merger it will only supply its input through its owned downstream operations (e.g. an oil producer could decide to solely supply petrol through its integrated distribution network). In the context of *customer foreclosure*, a downstream firm might decide that post-merger, it will solely purchase from its upstream integrated firm (e.g. a car manufacturer could refuse to purchase auto parts from non-integrated suppliers). Input foreclosure is associated with "Raising Rival's Costs" strategies in which there is no outright refusal to deal but post-merger, a vertically integrated entity would take into account the fact that raising the upstream price to downstream rivals would benefit the integrated downstream operations by shifting market share.[28]

26. At first sight, such strategies might seem appealing for the merging firms if the effect is to weaken significantly or exclude competitors, thus extending (or leveraging) market power from one market to another. Such exclusionary effect is possible but needs to be tested case by case. First, the integrated firm should have the *ability* to weaken or exclude competitors. This would the case if the integrated firm controls a scarce and essential input for which downstream rivals have no alternative (or if alternatives are very costly). In other words, the upstream firm must hold significant market power. Second, there should be an *incentive* to refuse to supply. Refusing to supply entails a *cost* for the integrated firm in the form of foregone profits. Indeed, by refusing to supply or by raising rivals costs, profitable sales (to non-integrated entities) are lost. The strategy will only be profitable if the lost profits upstream are compensated by increased profits downstream (through foreclosure). Finally, even if the ability and the incentive to foreclose can be demonstrated, this is only part of the story. As indicated above, competition authorities should ultimately be concerned with the *effect on consumers*.

27. Foreclosure should therefore be assessed in relation to the impact that any such strategy would ultimately have on the downstream price to consumers, taking into account the effect of raising rivals' costs on downstream prices but also the impact of pricing efficiencies (double mark-up elimination). Moreover, possible counter-strategies by rivals (e.g. integrating themselves or developing an alternative source of supply) or the scope for entry (or re-entry in case competitors are forced to exit) should be explored.

28. Another type of concern arising from vertical mergers relates to collusion and the ways in which a vertical merger might help collusive outcomes through improved information exchanges facilitating monitoring and the detection of cheating.[29] Through integration, companies may acquire direct access to information about their rivals (e.g. the prices quoted by an upstream competitor to an integrated distribution arm) or create a channel through which information is provided to their competitors. Of course, for such effect to arise, it must be shown that the industry is conducive to collusion and that the vertical merger will *change* the information flow conditions so as to enable collusive outcomes to emerge.

4. Conglomerate mergers: Foreclosure through bundling strategies

29. With conglomerate mergers, the main concern arises from the exclusionary effects of bundling or tying strategies.[30] Theories of anti-competitive bundling have been formalized in recent years. After years of "Chicago School" influence, the early economic literature on bundling focused on the price

28 Customer foreclosure is generally associated with the effect of reducing upstream rivals' revenues (rather than increasing their costs) and the impact this may have on incentives to invest. Such effects typically arise in the longer run (compared with the effects of input foreclosure).

29 The 1984 US Guidelines on Non-Horizontal Mergers also explicitly raises this risk (www.usdoj.gov).

30 These were the main theories of harm in the *Tetra Laval / Sidel* and *GE / Honeywell* mergers. *op.cit*.

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discrimination rationale for a monopolist to offer bundles to customers with negatively correlated preferences, suggesting that there can be justifications (as indicated earlier) for selling products together that are independent from exclusionary motives.[31]

30. Several theories of competitive harm from bundling have been developed in particular settings (competitive or oligopolistic structures, with specific distributions of customer valuations, with complementary or independent products, with or without network externalities, etc…).[32] In each case, the exclusionary effect arises under a given set of circumstances. Generally, the exclusion of rivals (or the deterrence of entry) through bundling has been found in cases in which a *commitment* to bundle in the case of entry can be made[33] or in models where bundling today shifts sufficient demand away from rivals and reduces future competition.[34]

31. In these models, exclusionary effects tend to emerge when there is market power in at least one of the markets, when economies of scale may affect the scope for entry or profitable expansion on some of the markets, when customer preferences are such that exclusionary consequences are likely and when rivals have possible no counter-strategies to respond to bundling (such as creating their own bundle).

IV. What are the lessons from economic theory to inform competition policy towards NHM?

32. Our review of possible theories of harm in the context of NHM shows that the economic literature is not yet "settled". There is no unified theory of foreclosure[35] but an array of models that identify circumstances in which foreclosure might arise and the mechanisms leading to foreclosure. On the one hand, this may seem insufficient to appropriately guide policy makers. On the other hand, these models offer useful guidance about the circumstances in which foreclosure effects are *unlikely* and the necessary (though not sufficient) ingredients of a foreclosure story.

33. The guiding principles that emerge from the literature on foreclosure effects from NHM have been summarized by the EAGCP in five main points, which derive from our discussion of the efficiency rationale of NHM and the set of theories of harm that can be developed. First, NHM are fundamentally different from horizontal mergers (because of the nature of the products); Second, anti-competitive effects tend to be indirect and arise from a change in behaviour whose ultimate impact on consumers is generally ambiguous; Third, there are many potential theories of harm and the investigation of NHM should investigate the mechanism through which customers are expected to be harmed; Fourth, the existence (pre-merger) of market power in at least one of the markets is a necessary ingredient of a theory of foreclosure; Fifth, the role of efficiencies tends to be more central in NHM.

V. Which direction is the Commission going?

34. Recent indications on the direction taken by the Commission in the draft guidelines on NHM are suggestive of a prudent approach towards mergers between firms that are not direct competitors, in line with the guiding principles outlined above. The Commission is likely to formally recognize the usually pro-competitive nature of NHM ("*generally less likely to create competition concerns*").[36] It is however unclear whether (and if so, to what extent) the efficiency motivation of any NHM under investigation will form an integral and central part of the analysis (as it should). The broad categories of possible competitive harm are likely to be described in the guidelines (input foreclosure, customer foreclosure, foreclosure through bundling …) without focus on specific theories of harm. This is appropriate in the context where the economic literature on foreclosure is a set of possible "stories".

35. The Commission seems set to propose a general framework in which three steps would have to be completed during the investigation. These steps make sense and follow the main lessons from the economic literature, recognizing that foreclosure is a costly strategy and that even if implemented, consumer harm does not necessarily follow (even if competitors are worse off). First, the Commission will examine the *ability* to foreclose; second, the *incentive*

31 The price discrimination rationale means that through bundling, the firm is able to extracts consumer surplus. As is generally the case with price discrimination, some customers are typically better off while others are worse off. The overall welfare effect is ambiguous.

32 See the overview of the literature on bundling strategies by Nalebuff, *op.cit*.

33 See Whinston, Tying, Foreclosure and Exclusion, *American Economic Review*, 80, 837-859. In this seminal paper, Whinston shows that by committing to bundle a monopoly product A with product B can deter entry in product B. If there are scale economies, the commitment to bundle entails the prospect of aggressive competition which makes entry less attractive. The commitment assumption is crucial however to the result. Indeed, in the case of entry, the monopolist would want to sell its high-margin product A to customers purchasing product B from the entrant. A credible commitment (such as technical bundling) is the only way to achieve deterrence.

34 Carlton and Waldman, The Strategic Use of Tying to Preserve and Create Market Power in Evolving Industries, *Rand Journal of Economics*, vol 33(2), pages 194-220.

35 As the Economic Advisory Group for Competition Policy (EAGCP) puts it "There is no generally agreed set of 'canonical models' of competitive harm to provide guidance for non-horizontal mergers" (see point 3. in the "Ten Principles").

36 See the presentation by Carles Esteva-Mosso, *op.cit*.

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to foreclosure will be assessed.[37] And finally, the strategy's *impact on effective competition* will be analyzed – taking into account countervailing factors and likely responses by rivals.[38]

Conclusions

35. After the Tetra Laval/Sidel and GE/Honeywell defeats, a clarification of the Commission's thinking regarding NHM is to be welcome. The initial indications on the future guidelines suggest that the Commission is set to take on board the lessons from the economic literature on vertical and conglomerate mergers and limit itself to providing general guidance, recognizing the different nature of NHM and the lack of a unified theory of foreclosure. This is the appropriate approach in a context where the mechanisms generating anti-competitive effects in NHM depend on specific sets of circumstances but also given the generally pro-competitive rationale that motivate such mergers.

36. Given that the same mechanisms of anti-competitive effects arise with NHM and exclusionary conducts under Article 82, consistency between the two sets of guidelines should be achieved. At this stage however, the approach suggested in the Article 82 Staff Discussion Paper and the expected approach in the NHM draft guidelines rather appear to be diverging. When general and sound guiding principles appear to be advocated in the latter, a set of presumptions and specific tests for each kind of strategy are proposed in the former. Hopefully, both sets of guidelines will in the end converge. ■

37 This aspect of the analysis calls for empirical analysis of the profitability (i.e. costs and benefits) of a given strategy. In the context of vertical mergers, the "vertical arithmetics" methodology can be implemented to evaluate the profitability of post-merger strategies. See also "Vertical Arithmetic – The use of empirical evidence in vertical mergers", Competition Memo, Penelope Papandropoulos and Bob Stillman, November 2005, Available at www.crai.com

38 As a result of the CFI Judgments in *Tetra Laval* and *GE* (*op. cit*), the Commission will also have to look at the likely deterrence effect of Article 82 investigations for post-merger strategies that could be caught by the Article 82 prohibition. Conceptually, the prospect of a fine should be incorporated in the cost/benefit analysis of foreclosure strategies.

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