RBB Brief 63

RBB Economics

Digging in the Scrap Heap!
A new theory of adverse buyer power

1. https://ec.europa.eu/commission/
    presscorner/detail/en/ip_20_801

2. RBB Economics advised the parties
    during the phase II investigation.

3. See paragraph 61 of the
    Guidelines on the assessment
    of horizontal mergers under
    the Council Regulation on the
    control of concentrations between
    undertakings, 2004/C31.

4. *Ibid*.

5. For more detail on these traditional
    buyer power theories of harm see
    "The Competitive Effects of Buyer
    Groups", a report prepared for the
    OFT by RBB Economics, January
    2007. https://www.rbbecon.com/
    downloads/2012/12/oft863.pdf

6. On the output market, the parties
    compete not only with other refiners
    that recycle copper scrap, but also
    with refiners that use primary
    materials.

1. Introduction

On 4 May 2020, the European Commission ("Commission") unconditionally cleared the acquisition of Metallo by Aurubis, following an in-depth investigation which included the sending of a Statement of Objections ("SO") to the Parties and an oral hearing.[1,2]

The Commission was concerned that this merger, by combining the two largest purchasers of copper scrap in the EEA, would give rise to significant buyer power, enabling the merged entity to impose lower prices for the copper scrap it acquires. Whilst increased buyer power usually benefits consumers, as lower input costs often translate into reduced product prices, in some cases imposing lower prices on suppliers could result in a significant impediment of effective competition ("SIEC"), as indicated in the EC Horizontal Merger Guidelines ("Guidelines").[3]

In this Brief, we offer an economic perspective on the Commission's approach to investigate competition concerns stemming from increased buyer power that results from horizontal mergers, with particular focus on a new theory of harm.

2. Traditional buyer power theories of harm

The Commission was persuaded that the evidence did not support either of the two standard buyer power theories of harm that are described in the Guidelines.[4] According to the first theory, when input supply is fragmented, large buyers may be able to reduce their purchases in order to pay less for their input. If a merger combining two large buyers resulted in the merged entity cutting its demand for inputs, this could lead to a contraction in supply on the downstream output market, pushing downstream prices up, and thereby harming consumers.

The second theory is quite different. According to that theory, the increased buyer power would allow the merged entity to secure a lower price for the input in question, which in turn would give it a significant advantage vis-à-vis downstream competitors. Owing to these lower costs, the merged entity could undercut its rivals. If those rivals were forced to exit the market, this might lead to higher downstream prices, to the detriment of consumers.

For either of these theories to hold, the merged entity would need to have enough market power on the downstream market to raise the price of copper.[5] This condition was not met in Aurubis/Metallo. The Commission eventually agreed that the Parties face significant competition from the supply of copper originating from primary materials.[6]

3. The Commission's novel buyer power theory of harm

Nevertheless, the Commission formally raised objections against the proposed transaction, based on a novel buyer power theory of harm. This theory posits that, by reducing the price of copper scrap, the merger would affect adversely sellers of this type of scrap, which would then lead to an increase in the price of many industrial products, thereby harming consumers. To see this, the Commission's novel theory can be broadly described in terms of a two-stage process.

First, a transaction that combines two large buyers might result in the merged entity paying lower prices for its inputs. The process through which this can happen is the mirror image of that for a merger between two competing sellers that would give rise to a price increase. In the procurement market, the parties compete to purchase copper scrap from numerous suppliers. The proposed transaction would eliminate this competitive constraint, so that, post-merger, suppliers of scrap would have fewer alternatives to sell their materials; and in consequence the price of inputs would fall.

The second stage of this theory of harm connects how a reduction in the price of copper scrap affects consumers. The process through which this price reduction results in consumer harm is not described in detail in the Decision. But, simply put, the idea is that the reduction in the price of copper scrap would be first transferred up the supply chain, until it reaches those that generate the waste, including industrial suppliers, such as car manufacturers. This mechanism is represented on the left-side of Figure 1 below, which shows that the merger-induced price reduction of copper scrap, if transmitted by intermediaries, affects ultimately industrial suppliers.

Figure 1: From a price reduction of copper scrap to a price increase for consumers
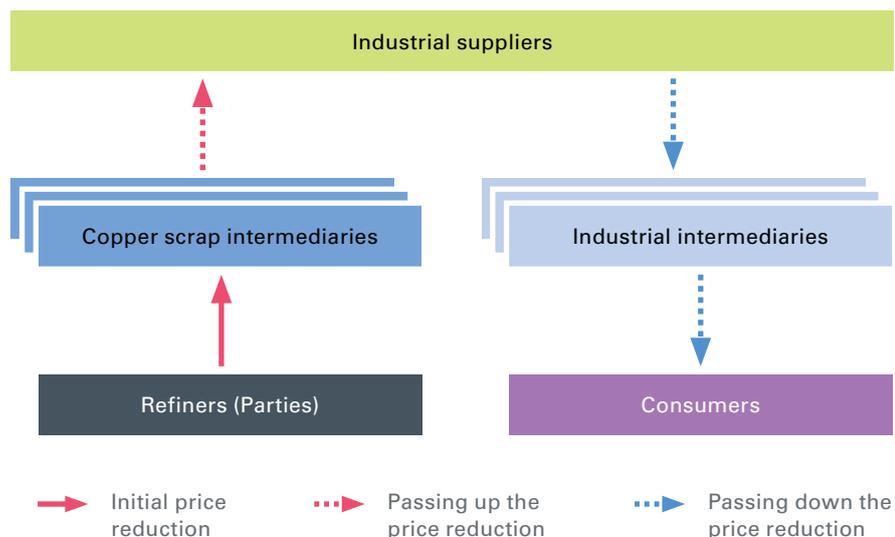
Source: Schematic depiction of EC reasoning by RBB

According to the Commission, industrial suppliers affected by the reduction in revenue brought about by the price decrease of copper scrap would suffer an increase in their effective costs of production.[7] This is because the revenue that they obtain from selling copper scrap generated by industrial processes can be deducted from expenditures on factors of production, effectively reducing the (net) costs of production. In other words, if it brings additional revenue, recycling copper scrap reduces the cost of inputs and, hence, the effective costs of production. By the same logic, if the proposed merger would reduce the revenue that manufacturers earn when selling their scrap, this is equivalent to raising their costs.

Confronted with a "cost increase", the Commission argued that industrial suppliers would be expected to raise the price of the products they manufacture, ultimately harming final consumers. This mechanism is illustrated in the right part of Figure 1 below. As copper is used by many industries, the Commission was concerned that the potential harmful effects of the proposed transaction would spread widely, affecting numerous product markets.[8]

4. The Commission's approach dangerously lowers the bar for intervention

Even though it was not the conclusion of this investigation, the Decision indicates that if it were demonstrated that the increase in buyer power would lead to a cost increase for industrial suppliers, this would be sufficient to conclude that final consumers are harmed.[9,10]

That conclusion, if it were adopted, would set the bar required to suggest consumer harm at a dangerously low level for at least three reasons. First, it implies that simply showing that the merger would raise the cost of production of industrial suppliers is sufficient to conclude that final consumers would be affected. But this is not necessarily correct. The cost increase suffered by industrial suppliers might be insignificant, with no material influence on the price paid by consumers. This point can be illustrated using the example of the automotive sector, which, like many industries, uses copper as an input and in that process generates copper residues that can be recycled. Consider that the production of a standard passenger car requires approximately 70kg of copper. The process will generate some residues (which contain about 1kg of copper) that can be recovered and sold to the Parties for recycling.[11] Assuming hypothetically that the merger would give rise to increased buyer power, allowing the merged entity to lower price significantly, some simple calculations show that post-merger the cost of copper per vehicle would be raised by about € 0.04.[12] This is tiny on any measure. Even a significant increase in buyer power could not influence the cost of producing an automotive vehicle to any material degree, and consequently, even if this negligible cost increase were passed on in full by car manufacturers, this could not give rise to any material price change for consumers.[13]

Second, whilst an increase in buyer power would reduce the price the merging parties pay for copper scrap, there is no reason to expect that this price reduction would be passed in full all the way up the supply chain (see Figure 1 above). Whilst the Decision focusses on the cost increase suffered by industrial suppliers, it offers no guidance on how a reduction in the price of copper scrap would be transmitted through several intermediaries before reaching these suppliers. If the intermediaries absorbed part of the price reduction imposed by the merging parties, this might imply little or no reduction in scrap prices received by industrial suppliers. The "pass-up" analysis of a price reduction is thus an integral part of assessing the extent to which the cost of industrial suppliers would be increased post-merger.

Third, the Commission supposes that, if buyer power raises the cost of industrial suppliers, it can be presumed that this cost increase would raise the price of goods purchased by final consumers. This presumption goes too far. Indeed, under this approach the Commission would not even have to assess the extent to which the price of the product manufactured by industrial suppliers would be raised as a result of the cost increase caused by the merger. For instance, it may well be that the cost of using copper for these suppliers is elevated, even substantially. However, if copper represents a minor cost component (as is the case for manufacturing an automotive vehicle above), the price of the final product would hardly change. Yet, the Commission's approach presumes that this cost increase would affect final consumers.

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9. The Commission cleared the proposed transaction unconditionally on the ground that the post-SO evidence revealed that it would not give rise to a significant increase in buyer power.

10. "However, under the specific circumstances of the case at hand, the Commission notes that harm to consumers downstream could not be a priori excluded. If an increase in marginal costs for industrial suppliers were demonstrated, it could be expected as in seller power cases, that such increase would be passed-on by the Merged Entity's trading partners, at least partially along the vertical chain, and would therefore eventually negatively affect final consumers. In such a case, these price increases would likely be spread out over a large variety of different industries and thereby (ultimately) a variety of final consumers." Paragraph 404 of the Decision.

11. This example is based on Aurubis assumptions regarding the amount of copper that is used to manufacture a standard automotive vehicle and the amount of copper that can be recovered from the residues.

12. The price of copper scrap is based on the official price from the London Metal Exchange (LME) to which refiners subtract a refining charge, which here would be raised because of increased buyer power. Conceptually, copper scrap must be treated before it becomes copper again. The refining charge covers the cost of this process and is set by refiners. In this example, an increase in buyer power would result in a 10% increase of the refining charge, implying a reduction in the price paid to purchase copper scrap. This result would not change materially if the refining charge was raised by 25% or even by 50%.

13. Assuming that this cost increase is passed-on in full, if the price of a standard automotive vehicle is raised by €0.04, this would not affect car sales. Indeed, confronted with such a price increase, customers are unlikely to be discouraged to purchase new vehicles. In other words, the merger would not lead to any adverse, significant economic effects, except perhaps a transfer of €0.04 for each vehicle purchased to the copper recycling industry.

14. See paragraph 404 of the Decision.

15. This novel theory of harm could apply only when suppliers produce several products in fixed proportion from a joint production process. When a supplier manufactures different products from unrelated production processes, this theory of harm would not work. Even if a manufacturer makes several products from a joint production process but in variable proportion, this theory will not apply so readily. This is because the supplier could react by cutting down the production of the product that is the object of increased downward pricing pressure from buyers, without reducing the supply of other products sold in other markets.

16. To illustrate how the Commission novel theory of harm could be extended to this setting consider a hypothetical merger in the textile sector that would strengthen the purchasing power of the merged entity to the point that it could impose a lower price for its purchases of wool. This price reduction would affect sheep farmers, who also produce lamb meat. Assuming that raising sheep provides wool and lamb in fixed proportions, that price reduction on wool would result in an increase in the price of lamb, and thus harm consumers. This is because, confronted with a reduction in the price of wool, a sheep farmer would have an incentive to cut down on the number of sheep reared, which in turn would push up the price of lamb.

17. The possibility of such procompetitive effects of reduced purchasing prices is recognised in paragraph 62 of the Guidelines and paragraph 63 prescribes that an "evaluation of both positive and negative effects" of an increase of buyer power would be required.

5. Conclusion

The novel buyer power theory of harm developed in the Aurubis/Metallo Decision would allow the Commission to raise competition concerns and possibly prohibit a broad class of horizontal mergers that increase buyer power, even if these would not result in any significant consumer harm. The Decision clearly states that once the Commission has demonstrated that the costs of industrial suppliers have been increased by the merger, irrespective of the magnitude of such increases, it can be presumed that the price of products sold by these manufacturers would be elevated, ultimately harming consumers.[14]

This novel theory of harm could be applied more broadly against horizonal mergers in various industries, and not just copper scrap. For instance, this theory could be pursued against the merger of firms specialised in the recycling of waste generated by production processes. The same theory could be used also against horizontal mergers that affect adversely suppliers that produce several goods in the same process.[15] There are numerous such examples in the agricultural sector (beef and hides, lamb and wool), in the mining sector (several minerals can be excavated from the same mine), in the transport sector (several destinations may be served with the same vehicle) etc.[16]

More concerning, this new approach to buyer power could open the door to complaints against transactions that improve the purchasing power of customers. In many cases, the merging parties argue that procurement is a large contributor of their planned cost synergies. Often, the parties expect that, when combined, they will be able to reduce their expenditures from suppliers. Aided by this new theory of harm, some input suppliers, fearing the adverse impact of a transaction, could submit that the merger in question would harm consumers, by simply showing that their revenue would be reduced post-transaction.

Moreover, and importantly, any consumer harm established under such a theory of harm should be weighed against any pro-competitive effects that stem from buyer power.[17] However, as the evidentiary standard set by the Commission is vastly uneven, the outcome of the balancing exercise is unlikely to favour the merging parties. To recall, a merger that increases buyer power can deliver significant benefits for consumers. Indeed, strengthened purchasing power can lower the cost of the merging parties, resulting in price cuts on the downstream markets. Because these cost savings would fall in the "efficiency defence" category, the merging parties would bear the burden of demonstrating, and even quantifying, the pro-competitive effects. In sharp contrast, according to the Aurubis/Metallo Decision, the Commission can simply presume that if suppliers' costs are increased, this would result in a higher price, harming consumers.