December 2018

RBB Brief 58

RBB | Economics

Beyond internal documents: the Commission's recent conglomerate effects practice

In January 2018, Commissioner Vestager highlighted how internal documents have shaped the Commission's assessment in recent cases, and announced her intention to publish a set of best practices on requests for internal documents in merger investigations.[1] The Commission has indeed shown an increasing reliance on internal documents in its recent merger practice, and now seems to devote a substantial part of its investigation efforts to the gathering and review of these.

Internal documents, however, are only one of several inputs into a complete merger assessment – whilst findings from internal documents can be informative, the economic assessment of the market evidence available remains crucial to test any such findings and put them in context. When assessing past competitive interactions, any opinions or perceptions contained in internal documents need to be tested against actual market outcomes. Where internal documents point to a possible future conduct, economic analysis is key to assess both the likelihood of that conduct arising in practice and the scope for it to ultimately give rise to anticompetitive effects.

The importance of an economic assessment has been reflected in both *Essilor/Luxottica* and *Qualcomm/NXP*, two recent conglomerate mergers in which the Commission considered the scope for the merged entity to engage in anti-competitive tying and bundling practices.[2] Although internal documents played an important role in these two cases, they were not, and could not have been, decisive. Indeed, while the Commission relied significantly on internal documents to analyse the Parties' *incentive* to engage in tying or bundling practices, it ultimately concluded – largely on the basis of economic evidence – that any such practices could not result in anti-competitive *effects*.

This Brief discusses the Commission's assessment of these two cases, drawing some general conclusions on its current approach to conglomerate effects.

Two textbook conglomerate mergers

Essilor/Luxottica and *Qualcomm/NXP* represent textbook examples of a conglomerate merger between producers of complementary products.

In *Essilor/Luxottica*, the Commission's main theory of harm was whether the merged entity could use tying and bundling practices to leverage Luxottica's market position in spectacle frames and sunglasses towards the ophthalmic lenses market, in which Essilor was active.

In *Qualcomm/NXP*, a core theory of harm considered by the Commission was whether the merged entity could engage in anti-competitive tying or bundling between Qualcomm's baseband chipsets (BC), which manage the radio functions of a smartphone, with NXP's chipsets of so-called "near-field communication" (NFC) and "secure element" (SE), which allow smartphones to communicate with devices located nearby.[3]

In both cases, the Commission assessed the likelihood of anti-competitive tying, pure bundling, or mixed bundling emerging post-merger,[4] and it did so following its usual "three-step" framework: it assessed whether the merged entity would have both the *ability* and the *incentive* to engage in the foreclosure strategy, and whether such strategy would have negative *effects* on consumers.[5]

1. Speech of Commissioner for Competition, Margrethe Vestager, "Fairness and competition", GCLC Annual Conference, Brussels, 25 January 2018, available at https://ec.europa.eu/commission/commissioners/2014-2019/vestager/announcements/fairness-and-competition_en.

2. See the decision in Case M. 8394 – Essilor/Luxottica (2018), and the decision in Case M. 8306 – Qualcomm/NXP Semiconductors (2018). RBB Economics advised Essilor and Luxottica in *Essilor/Luxottica*, and Qualcomm in *Qualcomm/NXP*.

3. NFC and SE are used, for example, for contactless payments.

4. Tying makes the sale of Product A conditional upon the buyer purchasing Product B too, but where Product B is still available separately; pure bundling occurs when Products A and B are only sold together; with mixed bundling, Products A and B are offered separately, but are also sold together at a discount. These practices are conceptually very similar; pure bundling is akin to tying from both ends, and is also akin to a mixed bundling scheme whereby the price of the individual goods are set at a very high level.

5. *Guidelines on the assessment of non-horizontal mergers under the Council Regulation on the control of concentrations between undertakings*, 2008/C 265/07 ("the NHMG"), paras. 91-121.

Ability: market shares and beyond

First and foremost, the Commission's assessment of "ability" involves an analysis of market power in the leveraging or tying market, with an important focus on **market shares**. However, there are other considerations that can significantly impact the assessment. While these considerations were not relevant to *Qualcomm/NXP*, where the Commission found that the "ability" condition was met, they were relevant to *Essilor/Luxottica*, where the Commission ultimately concluded that there would be no "ability" to foreclose despite significant market share levels.[6]

Specifically, although Luxottica's market share on spectacle frames was modest (around 10-20% in the EEA), its market position on sunglasses was much stronger (40-50% in the EEA overall, and above 50% in a number of countries). The Parties nevertheless argued that any **bargaining power** that Luxottica could enjoy vis-à-vis opticians was ultimately constrained by the fact that sunglasses only accounted for a very small proportion of an optician's business; lenses, on the other hand, represented the majority. Importantly, opticians were shown to have a strong preference for multi-sourcing from different lens suppliers – the ability to offer lenses with a wide range of qualities and price levels was important for them, in order to be able to cater for all consumer demands. As such, it was unlikely that opticians would abandon their preferred commercial strategy with regard to the primary focus of their business (lenses) in order to adhere to a tie/bundle involving a product of secondary importance (sunglasses).

Whilst the Commission accepted that Luxottica's products accounted for a relatively modest proportion of opticians' profits, it still devoted a large part of its investigation to assessing whether Ray-Ban – Luxottica's most important brand – should be characterised as a **"must-have" brand**.[7] The Commission's concern was that despite sales of Ray-Ban not accounting for a significant proportion of an optician's profits, stocking the brand could bring additional value to the optician over and above the sales of the brand itself, in particular by generating consumer traffic in its store.

In this context, it is worth noting that there is a lack of clarity around the definition of what a "must-have" product is. A "must-have" product is not an economic concept, but a "business" term. Normally, neither complaints putting forward the term nor the Commission – which has used it in a number of cases – give a clear definition of it.[8] This, in turn, means that the discussion of whether a given product is a "must-have" or not often relies on overly qualitative judgements that ultimately add limited value to the assessment.

A sensible – and workable – definition of the term would be that of a product that is indispensable for customers to be able to conduct their business profitably and compete effectively. In line with this definition, in *Essilor/Luxottica*, the Parties submitted detailed statistics that showed that a large proportion of opticians (40-50% across the EEA) did not stock Ray-Ban, many of which were very successful and had been growing in the market. Moreover, the Parties showed that even among those opticians that stocked the brand, there was a high degree of variation in the *extent* to which they chose to do so, with many of them devoting to it only limited shelf space and selling only small volumes. These findings, which were confirmed by the Commission's market investigation in Phase II, were key to the Commission concluding that the merged entity would not have the "ability" to engage in foreclosure.[9]

Incentives: a focus on past practices and internal documents

Any tying or bundling strategy entails costs and benefits. For example, when making the sale of Product A conditional on customers also purchasing Product B, the main costs are the foregone sales to those customers that would have purchased Product A if offered separately but now do not accept the tie; the gains are the incremental sales to those customers that accept the tie and now also purchase Product B where otherwise they would not have done.[10] For the merged entity to have an incentive to engage in a tying/bundling strategy, the likely gains of the strategy need to outweigh its likely costs.

6. In the *Qualcomm/NXP* decision, the Commission put substantial emphasis on market shares, but – unconventionally – it discussed these and market power more generally before "ability", in a separate section. The discussion under "ability" focuses more on the literal ability to tie or bundle, rather than the ability to foreclose via tying/bundling (as set out in para. 99 of the NHMG).

7. *Essilor/Luxottica* decision, para. 444.

8. See the discussion around MIFARE in the *Qualcomm/NXP* decision, paras. 433-480, relating to a separate theory of harm that is not further discussed in this Brief. See also the decisions in *Microsoft/Skype, P&G/Gillette, SCA/P&G,* or *Kraft/Danone Biscuits*, among others.

9. *Essilor/Luxottica* decision, para. 444.

10. There is another stream of potential gains, which relates to those that could be generated on Product B via price increases in the long run, in the event of foreclosure. See footnote 11.

11. These are conceptually the same as so-called "vertical arithmetic analyses" in a vertical merger context. They are conducted in particular to assess tying and pure bundling, and sometimes they can entail difficulties that are not easy to overcome. For example, see *Qualcomm/NXP* decision, paragraph 743.

12. *Qualcomm/NXP* decision, paras. 712-717. *Essilor/Luxottica* decision, paras. 451 and 460.

13. In *Essilor/Luxottica*, neither the Chief Economist Team nor the Parties' economists engaged in any theoretical modelling exercise of incentives and effects. The same applies to *Qualcomm/NXP*, where although complainants made submissions using theoretical modelling, the Commission agreed with the Parties that their results were very sensitive to the underlying parameter values, and that they were therefore inconclusive (see *Qualcomm/NXP* decision, paras. 639-640).

When assessing "incentives", a **cost-benefit analysis** is often conducted. This type of analysis aims to simulate the likely costs and gains of the strategy by using margin information from the products involved and expected switching levels following the tie/bundle.[11] This analysis was conducted by the Parties in both *Qualcomm/NXP* and *Essilor/Luxottica*.[12, 13]

In practice, however, the Commission's assessment of "incentives" has placed significant weight on the analysis of **past practices** and **internal documents**.[14] The Commission's focus on past practices and internal documents is a natural reaction to the main criticism that the courts levelled at its decisions in *Tetra-Laval/Sidel* and *GE/Honeywell*, which was that its conglomerate effects concerns were overly speculative and not sufficiently based on hard evidence.[15]

With respect to **past practices**, in *Essilor/Luxottica*, the question of whether Luxottica had engaged in tying or pure bundling between sunglasses and frames pre-merger could shed useful light on whether it was likely to do so between frames/sunglasses and lenses post-merger.[16] The Parties submitted detailed customer-level analyses of Luxottica's sales data that showed that there was no relationship between the value of sunglasses it sells to an optician and the value of frames it sells to that optician. It therefore could not be the case that Luxottica was pushing opticians who bought sunglasses to also buy frames in fixed proportions.[17]

An analysis of past practices was also conducted by the Parties in *Qualcomm/NXP*. The Parties showed that following the previous (comparable) acquisition of Atheros, a supplier of Wi-Fi and Bluetooth chips, Qualcomm had only engaged in (pro-competitive) mixed bundling with its baseband chipsets, and had continued to offer both products separately – in other words, it had not engaged in tying or pure bundling.[18] This was used by the Commission to support the finding that the merged entity was unlikely to engage in tying and pure bundling between Qualcomm and NXP's chipsets.[19]

Regarding **internal documents**, in both *Essilor/Luxottica* and *Qualcomm/NXP* the Commission requested and analysed a very large number of documents to assess "incentives". In both cases, the fact that no internal documents were found was used to support a lack of incentives to engage in tying or pure bundling, and the finding of documents setting out future plans were used to support the existence of incentives to engage in mixed bundling.[20]

Importantly, the role that internal documents can play in the assessment of conglomerate effects is even more limited than for other concerns. This is because, as recognised by the NHMG, tying and bundling are universal business practices and are in the vast majority of cases *pro*-competitive.[21] Therefore the simple finding of a document that points to future plans of tying/bundling is not per se conclusive or problematic, as the assessment still needs to address the question of whether or not such practice is likely to generate anti-competitive *effects*.

Effects: last but not least

In its assessment of "effects", the Commission has shown a particular willingness to engage in the review and production of economic evidence. Indeed, recent practice suggests that in cases where both the "ability" and "incentive" conditions are met, the economic analysis of "effects" is likely to be decisive.

For a tying/bundling practice to be anti-competitive, two main conditions must be met. First, buyers need to accept the tie/bundle in question, thereby switching significant volumes away from rivals on the leveraged (or tied) good. Second, the decrease in volumes faced by rivals needs to affect their ability to compete, allowing the merged entity to raise prices for the leveraged (or tied) good.[22]

The first step in the assessment of "effects" therefore requires an analysis of the likely **customer responses** to the tie/bundle. In markets where demand is concentrated and there is buyer power, the purchase decision of one particular buyer can affect the viability of certain suppliers, and such a buyer should therefore be expected to take this into account when deciding whether to accept a tie/bundle or not.

14. As noted in para. 109 of the NHMG: "in its assessment of the likely incentives of the merged firm, the Commission may take into account[...]the type of strategies adopted on the market in the past or the content of internal strategic documents such as business plans".

15. See, for example, the ECJ's judgment on *Commission v. Tetra Laval*, paras. 37-51.

16. The fact that a given firm has not engaged in tying/bundling between Product A and Product B does not necessarily mean that it will not have an incentive to do so between Product A and Product C. Nevertheless, experience from recent cases suggests that – understandably – it is much harder for the Commission to find tying or bundling likely by a firm that has not engaged in such practices in the past.

17. *Essilor/Luxottica* decision, para. 457.

18. For a description of these practices, see Footnote 4 above.

19. *Qualcomm/NXP* decision, para. 578.

20. In *Essilor/Luxottica*, the Commission concluded that the merged entity would have an incentive to offer "complete jobs" (frames/sunglasses and lenses combined) at a lower price than if purchased separately. See *Essilor/Luxottica* decision, paras. 465-471. See also *Qualcomm/NXP* decision, paras. 591-596, 601-626, 633.

21. NHMG, para. 93.

22. NHMG, para. 111

In *Qualcomm/NXP*, demand for chips was concentrated in the hands of a few large producers of mobile phones such as Apple, Samsung, and Huawei. The Parties showed that these customers had a strong preference for multi-sourcing and mixing-and-matching – they tended to source baseband chipsets from both Qualcomm and other suppliers, and even when they purchased them from Qualcomm, they often did not choose the (mixed) bundle with Wi-Fi and Bluetooth chipsets that the firm offered and preferred to purchase from standalone producers of these chipsets. Following this, such buyers were expected to resist any hypothetical foreclosure strategies on the part of Qualcomm post-merger.[23, 24]

Importantly, buyer power is not necessary for customer responses to impact the assessment – customer *preferences* also matter. In *Essilor/Luxottica*, although the demand side was more fragmented, the strong preference on the part of opticians for offering a wide range of lens qualities and prices meant that the tying/bundling strategy at issue was unlikely to capture a substantial amount of additional lens volumes.[25]

The question of whether customers will accept the tie/bundle or not also depends on the **reactions by rivals**. In *Qualcomm/NXP*, the Parties argued that rivals could respond by putting forward their own competing bundles, and this was considered by the Commission as supportive to the conclusion that adverse effects were unlikely.[26] In *Essilor/Luxottica*, the Parties also highlighted that there would be competing bundles, but – more importantly – they argued that competitors enjoyed considerable margins and could therefore immediately respond by cutting the prices of their own standalone products. In its decision, the Commission did not take a position on this particular issue, as it instead focused the discussion of "effects" on the impact that the strategy could have on rivals' ability to compete in the absence of a response by these.[27]

As mentioned above, even if customers accept the tie/bundle, there is still the need to show that the resulting reduction in rivals' sales will affect those rivals' ability to compete. This largely depends upon **economies of scale**. For example, according to the theory of harm the Commission considered in *Essilor/Luxottica*, the merged entity would "steal" business from its lens rivals via bundling/tying, thereby increasing substantially their cost per unit and – as a result – preventing them from competing effectively. The Parties showed, however, that in the production and distribution of lenses, scale economies were limited and exhausted at low levels of production – a large reduction in the number of lens units produced by a given rival could not possibly result in a large increase in its unit costs. This was an important factor to the Commission's conclusion that anti-competitive effects were unlikely.[28]

Conclusions

In recent years, the Commission's merger practice has shown an increased reliance on internal documents. In light of the public statements made by Commissioner Vestager, this follows a determined policy change and is set to continue. In principle, the introduction of a more comprehensive review of internal documents in merger cases should not be by itself a negative development – whether it will ultimately be beneficial or detrimental to competition policy will depend on the exact role that internal documents are given in actual investigations.

Whilst internal documents can be informative, they are only one of several inputs into a complete merger assessment. This has been reflected in the Commission's review of *Essilor/Luxottica* and *Qualcomm/NXP*: for these two recent conglomerate mergers, whilst the Commission used internal documents to assess if there would be an *incentive* to engage in a tying or bundling strategy post-merger, economic analysis played a crucial role in its assessment of whether such strategy would generate harmful *effects* or not. These two cases have clearly shown that internal documents can be a good complement to the economic assessment of mergers, but not a substitute for it.

23. *Qualcomm/NXP* decision, paras. 647-658.

24. In *Qualcomm/NXP*, the Commission concluded that the "effects" condition was met by a specific strategy of interoperability degradation, but not by a strategy of mixed bundling. Interestingly, these practices are conceptually akin to each other – the main difference between them is that interoperability degradation is *technical* (related to quality) whilst mixed bundling is *commercial* (related to price). By the same token, interoperability degradation can be seen as a less restrictive form of pure bundling, a strategy for which the Commission also found "effects" unlikely. The Commission has also raised concerns about technical tying or bundling in other recent cases, where – as in *Qualcomm/NXP* – it ultimately required behavioural commitments to address these (see *Microsoft/LinkedIn, Broadcom/Brocade*, and *Dentsply/Sirona*).

25. *Essilor/Luxottica* decision, paras. 459, 470-471, and 484.

26. *Qualcomm/NXP* decision, paras. 656-657, 660-664.

27. *Essilor/Luxottica* decision, paras. 474-491.

28. *Essilor/Luxottica* decision, paras. 485-487. See also *Qualcomm/NXP* decision, para. 659.