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Gold Circle/Kenilworth Racing, a case of "horizontal" complements

Complementarity is a dynamic that the European Commission has wrestled with in many high profile merger investigations such as GE/Honeywell, EdF/British Energy, TomTom/TeleAtlas, Lufthansa/SN Airholdings, and Universal/EMI. It affects sports rights, standards essential patents, media and transport, it is central to some of the more complex vertical foreclosure and abuse theories of anti-competitive harm, and it is a primary motivation for many pro-competitive joint ventures and "horizontal" agreements. In October 2012, the Competition Tribunal of South Africa ("Tribunal") examined complementarities in detail in the course of a three week oral hearing, following which it overturned an earlier decision by the Competition Commission ("Commission") to prohibit two linked mergers in the South African horseracing industry, approving the transactions subject to a minor employment-related condition.[1]

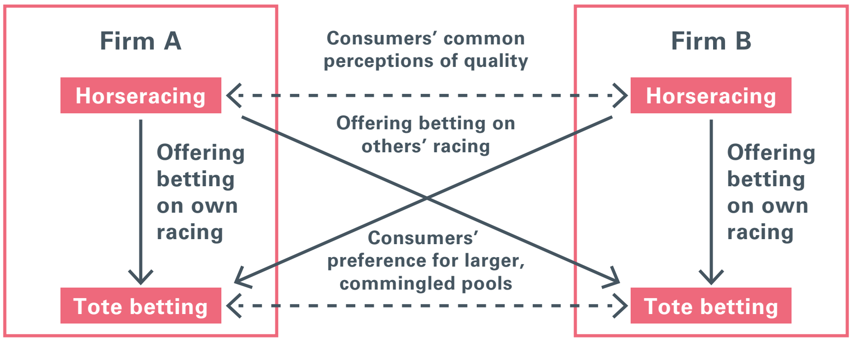
This case presents a compelling example of economic activities acting as complements, such that a merger of two firms, although active at the same levels of the supply chain, was likely to have a pro-competitive impact. The transparency of the South African process allowed the thorough assessment of three related topics: the complementaries between the two parties at different stages of the supply chain, the double-sided nature of the relevant markets, and the interactions across sets of related markets. Similar logic and techniques are currently applied to the investigation of potentially pro-competitive dynamics in myriad other situations, which are starting to be recognised by agencies globally.

In this Brief we explore the nature of complementarities in this case, and discuss more generally how shortcuts and presumptions that are often simplistically applied to "horizontal" or "vertical" mergers can fail to properly identify the applicable economic incentives, and can thereby lead to erroneous conclusions in competitive assessments.

Background

Two operators administer the sport of thoroughbred horseracing in South Africa: Gold Circle in KwaZulu-Natal and the Western Cape, and Phumelela in Gauteng, the Free State, the Eastern Cape and the Northern Cape. Horseracing administrators stage race meetings and provide racing and training facilities in their respective provinces, and offer prize money ("stakes") and other subsidies to attract racehorse owners and trainers to the sport.[2]

The same two operators each have licences to offer totalisator ("tote") betting in the same provinces in which they administer racing.[3] Profits from these tote betting operations constitute the primary source of funding for the horseracing administrators. The following figure provides an overview:



1. *Kenilworth Racing (Proprietary) Limited / Gold Circle (Proprietary) Limited and The Thoroughbred Horseracing Trust / Kenilworth Racing (Proprietary) Limited, (Proprietary),* Case No: 36/AM/Apr12, CC Case Nos: 2011Dec0429 and 2011Dec0427, Decision of 15 November 2012, Reasons of 7 February 2013 ("Tribunal Decision") (http://www.comptrib.co.za/assets/Uploads/36AMApr12-014845.pdf). RBB Economics provided economic analysis, advice and expert testimony on behalf of the merging parties throughout the Commission investigation and the Tribunal hearing.

2. Despite these stakes and other subsidies, thoroughbred horseracing remains heavily loss making for the average owner.

3. Phumelela operates tote betting services in 3 additional provinces where horseracing does not take place: Mpumalanga, Limpopo and the North West. Tote, or pari-mutuel betting involves punters placing bets on an uncertain outcome, the total bets are pooled together, a take-out is extracted for the operator, and the remaining pool is divided amongst the winning punters – accordingly the odds, or pay-out ratios for particular outcomes may vary from the time at which the bet is placed to the time of the final pay out. Bookmakers offer fixed-odds betting services on horseracing, among other things.

The Tribunal considered the transactions on the assumption that they represented the acquisition by Phumelela of control over the Western Cape business of Gold Circle, Kenilworth Racing.[4] That is, the operator of horseracing in 4 of the 6 provinces in which racing took place, taking over racing in a 5th province, and the operator of tote betting in 7 of 9 provinces, taking over tote betting in an 8th province.

The Commission's theory of harm

The Commission considered that this concentration would lead to a substantial lessening or prevention of competition in the horseracing administration and betting markets.[5] In regard to each activity the Commission's theory of harm was based on a structural presumption of harm that flowed directly from national market definitions. At first glance this may seem intuitive.

In regard to horseracing administration, the Commission considered that horseracing administrators competed with one another by offering stakes to attract owners and trainers to race horses in their respective provinces.[6] In that context, the Commission expected the transaction to reduce stakes and the quality of racing and training facilities, particularly as the target, Kenilworth Racing, was surrounded by provinces in which Phumelela was active.

In regard to tote betting, the Commission considered that different tote betting operators competed in national markets for betting on horseracing (as distinct from betting on other sports or activities).[7] In that context, the Commission expected the transaction to enable Phumelela to exercise market power to the detriment of punters.[8]

However, the assessment of competition additionally required a consideration of the incentives and dynamics that actually drove these markets, and an analysis of the nature of the interactions between operators. It was the consideration of these factors that turned the conventional structural presumptions on their head.

There is no substitute for a proper analysis

A common taxonomy of mergers distinguishes "horizontal" from "vertical" (or more generally non-horizontal) mergers. The Act defines a "horizontal relationship" as one "between competitors" - this is echoed in the UK OFT/CC and EC guidelines.[9] Such descriptions may seem intuitive but can be unhelpful.[10] Conversely, classifying products and services according to the economic concepts of substitutes and complements provides the necessary precision to illuminate the dynamics that drive the competitive assessment.

Two products are substitutes if an increase in the price of one leads to an increase in demand for the other. A price increase for one brand of beer might increase demand for another similar brand of beer. With substitutes like these, the intuition behind unilateral effects analysis in mergers is clear – if a price rise by one brand was not profitable pre-merger, it may well be profitable post-merger, as some of the sales lost by the first brand would then be recaptured by the second. The merged entity is able to consider the recapture of these lost sales post-merger, although neither brand was able to do so independently pre-merger.

By contrast, two products would be complements if an increase in the price of the first leads to a decrease in demand for the second. A price increase for left shoes would not only decrease demand for those left shoes, but also for right shoes.[11] In this case a merger may lead to a fall in prices, reversing the logic in the case of substitutes.

This case provided an illustration of how to test substitutability in practice, and a compelling example of strong complementarities between the activities of two ostensible competitors.

4. Tribunal Decision, paragraphs 5, 30, 56-66.

5. In addition, the Commission raised concerns in relation to TV broadcasting. See Tribunal Decision, paragraphs 96-105.

6. Tribunal Decision, paragraph 72.

7. The Commission considered national betting markets for each of exotic and non-exotic betting on horseracing, although this distinction does not affect the discussion in this Brief.

8. The Commission also raised other concerns, including that the transaction would give Phumelela additional bargaining power against bookmakers.

9. South African Competition Act of 1998, Section 1(1)(xiii); in regard to vertical mergers: Section 1(1)(xxiii)(c)(i). Joint UK and CC Merger Assessment Guidelines (2010) *"competing products"* (paragraph 4.1.4), see also vertical mergers (paragraph 4.1.4), although paragraphs 5.6.2 and 5.7.17 do discuss complementarities. EC horizontal merger guidelines (2004): *"competitors on the same relevant market"* (paragraph 5), and non-horizontal merger guidelines (2008): *"different levels of the supply chain"* (paragraph 4).

10. Although the fact that there is no distinction between the treatment of horizontal and vertical mergers in the Act may be a tacit encouragement to assess effects outside of the standard presumptions.

Horses for courses

The substitutability between different horseracing venues was tested directly by considering the movements of horses between racecourses over time. Not only had only a small minority of horses moved between racing centres, but the movements were typically from the *higher* stakes regions to *lower* stakes regions.[12] The explanation for these movements was a grading system which set out a hierarchy of racing centres, with weaker horses required to move from elite to lower ranking venues. The Tribunal concluded that far from exerting any significant constraint on administrators in other regions, an administrator would set stakes to encourage owners within their local region to take up or continue their participation in the sport.[13] This is a common phenomenon – in the absence of significant opportunities for substitution (without the ability to cannibalise business from other operators), each operator can only aim to grow the market in which it operates.[14]

The underlying dynamic that drove the interaction between the two operators was that the consumers of horseracing (the owners, trainers, viewers and punters), in common with other sports enthusiasts, value an attractive and competitive contest, in which the outcome is uncertain. In horseracing this translates into consistent, high quality racing (in terms of reputation, integrity and fair play), and efficient scheduling. Moreover, there are common elements to consumers' perceptions about the sport that would apply on at least a national basis, most obviously through scheduling, but also through common perceptions of quality and integrity. The actions of one administrator, for example to reduce the quality of their own horseracing, would also have a negative impact on demand for the other administrator's racing. This dynamic drives the complementarity between the two horseracing operations.

Eyes on the prize

In the betting market, several legal constraints limited the extent of potential competition between tote operators physically located in different provinces and potentially confined attention to remote telephone or internet betting. However, the overarching dynamic that prevented conventional competition in these markets was the nature of consumer preferences.

In each province, the relevant tote operator accepts bets on local horseracing that it has staged, as well as on racing that takes place in other provinces where it is not the horseracing administrator. However, for each betting opportunity, e.g. the winning horse in the 2:00pm at Turffontein, all tote operators "commingle" bets into a single national pool. Punters have a strong preference for these larger commingled pools because there is greater stability in the expected pay-outs (payouts are less prone to distortions when large bets are placed), and larger pools offer the chance to win life-changing sums of money. These benefits would simply not exist with smaller pools drawn from each province on its own.[15]

Customer preferences for larger pools mean that the province that makes the largest contribution (already operated by Phumelela, pre-merger, in Gauteng province) has the ability to set pay-out rates for the commingled national pool. A threat by a smaller operator to withdraw from the national pool, e.g. to attempt to compete by improving payout rates, would simply not be credible, as this would dramatically reduce demand for its own offering, while also reducing demand for the remaining pool (albeit by a lesser extent). This preference for larger pools drives the complementarity between the two tote betting operations. Accordingly, the Tribunal concluded that competition between provincial tote operators did not exist pre-merger and was unlikely post merger.[16]

11. Similar dynamics are found in a range of situations, including printers and cartridges, and even hospitals in different regions that can combine to provide comprehensive coverage. In *Universal/EMI* the US FTC accepted the weight of evidence that different recorded music repertoires are complementary, each being important for a successful platform, like Spotify, rather than being alternatives, which might have been the case if platforms only required a limited range of music to compete effectively (see http://www.ftc.gov/os/closings/comm/120921emifeinstateinstatement.pdf).

12. A more detailed empirical assessment considered the movements, as opposed to levels, of stakes.

13. Tribunal Decision, paragraph 73. It would have been odd to conclude that the merger would reduce stakes in the Western Cape, given that the transaction was overwhelmingly approved by owners and trainers in that province (paragraph 76).

14. This dynamic featured heavily in the *Universal/EMI* merger review, for example considering the competitive terms offered by Universal, already the largest recorded music company pre-merger, to some 450 new digital music services over a four year period, in an attempt to grow the market, particularly in the face of piracy.

15. A similar dynamic drives a preference for larger lottery pools (which are also a form of pari-mutuel betting).

16. Similar reasoning applied to the assessment of broadcasting rights. Pre-merger, a joint venture between the administrators consolidated audiovisual content from their respective horseracing events, for distribution to domestic and international viewers.

High stakes complementarities – "competition" as a race to the bottom?

A complete analysis of market dynamics requires an appreciation of the linkages between each operator, active across both markets – horseracing administration and tote betting – effectively acting as a multi-sided platform linking together different groups of end consumers: primarily thoroughbred owners and trainers on the one side, and punters on the other side.[17]

Considering these two sides of the market, horseracing administration is heavily loss-making (the cost of stakes, racing and training facilities are not remotely compensated by attendance revenues), while tote betting is profitable.[18] There is thus an obvious incentive to engage in less horseracing and more tote betting. This drives a third, and extreme form, of complementarity between ostensibly "competing" operators which each have a strong incentive to free ride on the other's efforts in horseracing administration. Each operator would prefer to stage fewer and lower quality races in order to reduce its administration expenditure, yet to continue to earn revenues through offering punters bets on the other operator's racing. This dynamic would dramatically reduce output in each of horseracing and betting, for both operators, and act to the detriment of consumers.

A number of industry agreements mitigate the potential for such negative effects, by committing each operator to a minimum number and minimum quality of races.[19] However, a merger between these "competing" players would achieve an even more effective protection against such incentives to free ride and reduce quality and output. The Tribunal recognised the potential benefits sought by these industry agreements, and was also quick to dismiss concerns surrounding shifts in the bargaining power between operators as a matter of profit division between firms, as distinct from a theory of harm to consumers.[20]

Conclusion

This case provides an intriguing example of where structural presumptions, based on a cursory assessment of the level at which firms operate in the supply chain, can lead to erroneous conclusions that are at odds with the commercial reality of how markets work. The two operators of horseracing administration and tote betting activities may have appeared to be in "horizontal" relationships at first glance, and may even appear to be "competitors", to borrow the taxonomy from the legislation and guidelines.

However, a more detailed analysis of the way in which consumer preferences operate, and the factual circumstances surrounding these markets, revealed the opposite dynamic – complementarities between each of the common areas of activity, and an even stronger complementarity driven by the combination of these activities, which created incentives to reduce output and worsen quality. Happily, in this case the Tribunal appreciated that this is not the sort of "competition" that was ever intended to be protected by the Act, and reached a judgment that rightly approved an apparently substantial increase in concentration on the grounds that there was no potential harm to consumers. The reasoning behind this outcome provides a framework that has wider applicability in many other industries and jurisdictions.

17. The Tribunal Decision noted the two sided nature of horseracing operations, in respect of competition to attract each of horse owners and those who view the racing (paragraph 70).

18. Moreover, substantial feedback effects flow from one side of the platform to the others: stakes positively affect the number and quality of horses, which in turn positively affects betting turnover (e.g. through adding to the uncertainty and quality of the racing); betting turnover then flows back into stakes through arrangements between owners and the horseracing administrators.

19. The Tribunal Decision clearly recognises the potential output expanding effects of such agreements, particularly in regard to scheduling (see paragraph 79).

20. See Tribunal Decision paragraph 80, in regard to concerns concerning the scheduling of races across different operators, and paragraph 105 in regard to concerns that the transaction would lead to a change in the balance of negotiating power over joint broadcasting revenues.