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(Fore)closing the Gap: The Commission's Draft Non-Horizontal Merger Guidelines

Almost exactly 3 years after issuing its horizontal merger guidelines, the European Commission published draft guidelines on the assessment of non-horizontal mergers (i.e. vertical mergers and conglomerate mergers).[1] As the draft guidelines acknowledge, by virtue of bringing together complementary rather than substitutable products, non-horizontal mergers – whether vertical or conglomerate – give rise to substantial scope for cost and price efficiencies and are therefore predominantly pro-competitive.[2]

However, non-horizontal mergers may under certain particular circumstances give rise to anti-competitive outcomes. The draft guidelines state that the primary competitive concern in these cases arises where the merger denies the ability of rival firms to compete to such an extent that they are marginalised or driven from the market altogether. In such circumstances, a non-horizontal merger might result in increased prices through this foreclosure effect.[3]

But it is important to recognise that short-run effects that harm competitors also bring direct benefits to consumers. The analysis of potential anti-competitive effects must therefore carefully specify the conditions that give rise to the purported outcome, and must go beyond a mere theoretical assessment by accounting for observed industry characteristics and behaviour. This Brief presents some suggested changes to the draft guidelines that we believe would bring them more into line with established economic analysis and clarify how the potential anti-competitive effects of non-horizontal mergers can be assessed in practice.

What do we mean by "foreclosure"?

The draft guidelines draw a distinction between "foreclosure" and "anti-competitive foreclosure". Only the latter represents a competitive concern. However, even within the draft guidelines themselves the distinction is confused. At some points in the draft, "foreclosure" appears to be defined as anything that restricts access to supplies or to customers which subsequently gives rise to price increases, and elsewhere it appears to be defined as simply anything that makes competitors' lives more difficult. For example, the draft guidelines define foreclosure as *"**any** instance where actual or potential rivals' access to supplies or markets is hampered or eliminated as a result of the merger, t**hereby reducing these companies' ability and/or incentive to compete**"* (emphasis added).[4]

If the intended definition of "foreclosure" accords with the former interpretation, then it is unclear what differentiates "foreclosure" from "anti-competitive foreclosure". If the definition of "foreclosure" instead accords with the latter, this creates a risk that the guidelines will introduce an extremely low and unjustified hurdle to concluding that harm to competitors translates into harm to competition. More importantly, such a low hurdle would be at odds with the accepted view, reiterated in the draft guidelines themselves, that non-horizontal mergers generally do not give rise to competition concerns. The potential for confusion is of particular concern given statements in the guidelines as to the impact on rivals' revenue streams and the alleged consequential adverse effects for competition.[5]

1
"Draft Commission Notice. Guidelines on the assessment of non-horizontal mergers under the Council Regulation on the control of concentrations between undertakings", 13 February 2007.

2
For a comprehensive discussion of these efficiencies see "The Efficiency-Enhancing Effects of Non-Horizontal Mergers", RBB Economics, DG Enterprise, 2005.

3
Alternatively, entry or expansion may be deterred, allowing the firm to preserve its market power.

4
Draft guidelines, paragraph 18.

5
See draft guidelines, *inter alia* paragraph 64.

For the sake of clarity, it is critical that the term "foreclosure" should be confined to the situation where significant anti-competitive effects have been identified and, in consequence, that the distinction between "foreclosure" and "anti-competitive foreclosure" be removed.

Efficiencies: having the courage of one's convictions

Although the draft guidelines acknowledge the substantial scope for non-horizontal mergers to give rise to efficiencies,[6] the more detailed discussion of such efficiencies is relegated to after a discussion of the possible anti-competitive concerns. In our view, the guidelines would be a more balanced document and be more reflective of the likely competitive concerns raised by non-horizontal mergers if the respective sections on vertical and conglomerate mergers started with a discussion of how such mergers can give rise to efficiencies.[7] This would make it clear that any anti-competitive concerns arise *indirectly* via the marginalisation of competitors which is in marked contrast to competition concerns arising from horizontal mergers which arise *directly* via the potential elimination of one or more competitors.

Moreover, applying the two-step approach to appraising anti-competitive and efficiency implications used in the assessment of horizontal mergers is inappropriate for non-horizontal mergers.[8] In many instances, it is simply not possible to separate the assessment of competitive harm and the assessment of efficiencies. For example, the standard theories of harm raised by conglomerate mergers usually involve a short-run competitive advantage to the merging parties (often in the form of an ability to offer lower prices) which is alleged to result in the marginalisation of competitors and subsequently to the long-run detriment of competition. But clearly, the short-run price reduction also represents an efficiency that directly benefits consumers. In other words, the source of the potential competitive harm in this case is the same as the efficiency. We simply do not see how the two effects can be assessed separately, and indeed this is reflected in the fact that the draft guidelines provide no mechanism for performing a balancing act between the two effects.

A safe harbour that is not safe enough

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

In setting the safe harbour threshold, explicit account needs to be given to the likely impact on enforcement. Setting the threshold too "low" provides an open invitation for speculative complaints from competitors who fear the pro-competitive consequences of a non-horizontal merger. There are obvious and serious costs if this were to occur, including the prospect that benign mergers are prohibited, or become caught up in such a high degree of regulatory uncertainty that they are discouraged altogether. In contrast, setting the threshold too "high" carries fewer risks given that most non-horizontal mergers do not raise any competition concerns. In effect, the guidelines should adopt a bolder approach in restricting the number of cases in which complaints can be made by broadening the safe harbour.

6 See draft guidelines, paragraph 13 *et seq*.

7 See *inter alia* RBB Economics report for DG Enterprise, referenced in footnote 2.

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

Relationship with Article 82 reform

In sending the signal (albeit far too muted) that non-horizontal mergers predominantly give rise to benign or pro-competitive effects, the draft guidelines raise an important policy issue; namely, the discrepancy between the assessment of foreclosure under the Merger Regulation and the treatment under Article 82. Whereas the presumption set out in the draft guidelines recognises that harm to competitors does not necessarily, or even often, translate into harm to competition, the competitive assessment under Article 82 often takes a quite different stance; anything which harms competitors is necessarily assumed to harm competition.

For example, any loyalty rebate scheme employed by a firm held to be dominant is assumed to harm competition. But loyalty rebate schemes can provide similar efficiency promoting roles that have been identified with vertical restraints and vertical mergers; loyalty rebate schemes can be employed to eliminate double marginalisation, provide incentives for customers and reduce the divergence in incentives that exist between suppliers of goods and services and those that distribute their products. Having markedly different approaches to assessing the issue of foreclosure is unjustified from the perspective of the underlying economics. It will be interesting to see whether the stated move towards a more effects-based approach in implementing Article 82 will see the elimination of this discrepancy.

9
See for example the Opinion of Advocate General Kokott, Case C-95/04 P *British Airways plc v. Commission*, February 2006, paragraph 68.

Assessing the competitive impact in practice

The draft guidelines provide for a three step approach to assessing competition; these are essentially *ability*, *incentive* and *impact*. However, the interpretation of "foreclosure" that is adopted in the draft guidelines implies that these steps are "intertwined". In our view, the three steps can be seen as distinct stages in the analysis once a clear distinction is drawn between "foreclosure" and "anti-competitive foreclosure".[10]

For reasons discussed above, the first step, ability, should be revised to include a substantive screen for significant market power i.e. does one or both of the merging parties enjoy significant market power in a relevant market? To pass through this first filter, a non-horizontal merger must be shown to be capable of leading to anti-competitive effects. In the context of conglomerate mergers, for example, the ability step would also need to consider whether alleged post-merger practices (e.g. bundling) are possible.

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

The second step then relates to incentives. With respect to vertical mergers, a price increase to downstream customers, for example, is costly to the vertically-integrated firm since those customers will purchase fewer units. The consequence of this loss of sales may more than offset the benefits to the merging parties of the price increase. In general, it is likely that the costs will exceed the benefits if the merged entity has only a small presence in the market (upstream or downstream) in which foreclosure is alleged to be taking place. In conglomerate mergers, the incentive step is better interpreted as "what incentives does the merger change"? Although a conglomerate merger may bring together complementary products this does not necessarily imply that the merged firm will have increased incentives to engage in bundling.

For the third step, impact, we would propose the following sub-steps, each of which would need to hold in order to conclude that the non-horizontal merger would likely lead to anti-competitive exclusionary effects.[11] Since it is acknowledged that non-horizontal mergers do not generally give rise to competition concerns, foreclosure that results in higher prices to consumers needs to be proven and not assumed to follow inevitably once harm to one or

11
It is also possible that non-horizontal mergers can give rise to coordinated effects (see inter alia report for DG COMP, *The impact of vertical and conglomerate mergers on competition*, Church, 2004). This assessment is equivalent to the assessment of coordinated effects under horizontal mergers. Further, some theoretical papers essentially based on static models suggest that non-horizontal mergers may result in softened competition. Such theories are highly sensitive to underlying assumptions and hence provide a highly unreliable basis for policy intervention.

more competitors has been established. The conditions required for non-horizontal mergers to harm competition through foreclosure are as follows: [12, 13]

Condition A: *As a result of the merger, competing suppliers will lose volumes to the merged party and as a result are marginalised.* It is important to be clear as to what is meant by the marginalisation of competitors. For example, where a non-horizontal merger causes the merged entity to reduce its prices, this will adversely affect competitors in the sense that they will find it harder to make sales at the margins that prevailed prior to the price reduction. But, as noted above, price reductions are almost always to be welcomed as pro-competitive. A price reduction can be said to marginalise competitors only if, at any given price level, the competitive constraint provided by rivals were to be reduced following that (temporary) reduction. Similarly, the loss of access to supplies or customers will only marginalise a competitor if it adversely affects pricing decisions, by, for example, leading to an increase in short-run marginal costs.

Condition B: *Rival suppliers to the merging parties will find it unattractive or impractical to respond by adopting a similar strategy (or "counter strategy") that reduces the impact of the merged party's actions.* By merging with other firms or by arriving at equivalent contractual arrangements (so-called "teaming arrangements"), the rival suppliers may be able to deploy strategies that diminish or eliminate the competitive advantages of the hypothesised strategy (e.g. bundling or raising rivals' costs). The act of seeking and implementing such arrangements will often be an important part of the dynamic competitive process that is sparked by non-horizontal mergers. Where such responses to the merged firm's hypothesised strategy are plausible the competitive concern will be mitigated.

Condition C: *As a result of the above chain of events, a sufficient number of competitors are marginalised so that competition and consumers are likely to be adversely affected in the long-run.* In consequence, prices will increase and customer interests will be harmed. This can only occur if those competitors are marginalised to such an extent so as to significantly affect short-run marginal costs or be forced to withdraw permanently from the market.[14]

Conclusions

The Commission's draft guidelines represent a genuine and welcome attempt to clarify and provide guidance on its application of economic principles to EC competition policy. Our comments are intended to assist in providing a clearer and bolder framework for assessing the competitive effects of non-horizontal mergers. In identifying the fact that exclusionary effects arise (if at all) only indirectly, and generally only after consumers have benefited in the short-term, the draft guidelines establish some important principles for competition law enforcement that could also have beneficial effects on the development of enforcement in other areas, notably Article 82.

12
These conditions focus on the foreclosure of *existing* competitors. Analogous conditions can be derived for strategies aimed at excluding potential entrants.

13
These reflect, in addition to a significant market power screen, the same conditions proposed by RBB and accepted by the Commission during the investigation of *GE/Amersham*.

14
Competition could also be harmed if it could be shown that marginalisation had the effect of permanently reducing investment in new products. This is likely to be extremely difficult to prove in practice in a forward-looking merger assessment.