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Turning the Tables: Why Vertical and Conglomerate Mergers are Different

In February 2004, the European Commission issued its guidelines on the assessment of horizontal mergers.[1] Those guidelines set out the analytical approach that the Commission is meant to apply when assessing mergers involving firms that are actual or potential competitors on the same relevant market. The guidelines explain that a horizontal merger may significantly impede effective competition by eliminating an important competitive constraint on one or more firms ("non coordinated effects") or by changing the nature of competition so as to permit more coordinated behaviour by the remaining participants ("coordinated effects"). They then acknowledge that the efficiencies generated by the merger may enhance the ability and the incentive of the new entity to act pro-competitively for the benefit of consumers, thereby counteracting any adverse effects on competition which the merger might otherwise have.[2, 3]

During the course of 2006, the Commission is expected to issue new guidelines on the assessment of non-horizontal mergers. In developing non-horizontal merger guidelines, regard must be given to a number of key questions, namely: What are the differences between the competitive issues raised by horizontal mergers and those raised by non-horizontal mergers? What scope exists for non-horizontal mergers to give rise to efficiencies? Is the framework for the assessment of horizontal mergers appropriate for assessing non-horizontal mergers? This Brief comments on each of these issues.[4]

What are the differences between the issues raised by horizontal mergers and those raised by non-horizontal mergers?

There are important differences in the issues raised by horizontal and non-horizontal mergers. Horizontal mergers bring together manufacturers of substitute products and therefore remove a direct competitive constraint. Whether the removal of this pricing constraint leads to a price increase requires a detailed assessment. However, to the extent that the removal of this direct competitive constraint may be expected to lead to higher prices, such effects could be offset by the price-reducing effects of efficiency gains brought about by the merger.[5] The net effect may therefore be that prices fall.

In contrast, non-horizontal mergers bring together suppliers of complementary or unrelated products, and so do not directly eliminate a competitive constraint. Indeed, mergers of complementary goods generally provide an incentive for firms to lower prices, in line with consumer interests, since a reduction in the price of one good will increase demand for the other. For example, a reduction in the margins of a distributor will tend to increase the sales of those manufacturers' products it distributes. Similarly, a decrease in the price of cars may increase the sales of complementary products such as tyres. If firms are under separate ownership the beneficial impact of a price decrease (or quality improvement) on the other party's sales will not be taken into account. However, if the two parties merge, such mutually beneficial effects would be considered when setting each product's prices, resulting in lower prices.

Although such price reductions brought about by non-horizontal mergers are usually pro-competitive, they may, under certain circumstances, give rise to anti-competitive outcomes. The primary competitive concern in these cases is that post merger, the ability of rival firms to compete with the merged firm will be reduced to such an extent that they are marginalised or driven from the market altogether. Once this has occurred, the merged firm would then be able to increase prices.[6]

1 See "Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings" (2004/C 31/03).

2 See paragraph 77 of the Horizontal Merger Guidelines.

3 The assessment of such efficiencies is relevant primarily in the area of unilateral effects.

4 In 2005, RBB Economics prepared on behalf of the Enterprise Directorate-General of the European Commission a report on the efficiency enhancing effects of non-horizontal (i.e., vertical and conglomerate) mergers. See http://europa.eu.int/comm/enterprise/library/lib-competition/doc/non_horizontal_mergers.pdf. This Brief draws on the analysis presented in that report.

5 We do not subscribe to the view that all horizontal mergers necessarily give rise to an increase in price. Such predictions are posited on simple theoretical models which, although providing a useful analytical framework, do not provide a complete basis for making real-world policy predictions about the effects of mergers.

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

But while the scope for anti-competitive effects is a long run *possibility*, there is clearly an immediate and certain pro-competitive effect from the merger; only if a very particular set of conditions hold, do such short run pro-competitive effects ultimately lead to anti-competitive outcomes. This means that the presumption should be that non-horizontal mergers are pro-competitive.[7] Any theory of competitive harm must therefore not only carefully specify the conditions that give rise to alleged harm, but must go beyond a mere theoretical assessment of the anti-competitive possibilities by testing the theory of harm against observed industry characteristics and behaviour. In particular, it cannot be assumed that harm to competitors necessarily or even usually results in harm to competition.

7 Nowhere in the extensive literature on the competitive effects of non-horizontal mergers is this view disputed. Rather the dispute focuses on how many non-horizontal mergers fall outside of this general presumption.

What scope exists for non-horizontal mergers to give rise to efficiencies?

There is great scope for non-horizontal mergers to give rise to efficiency gains. As described above, there is a direct incentive to reduce prices or to improve quality post merger as this will increase the sales of the complementary products supplied by the other party to the merger. Furthermore, as products manufactured by firms in vertical and complementary relationships are, by definition, used together, non-horizontal mergers can give rise to numerous efficiency gains arising from improved interaction between the two products. Such efficiency gains often do not have a direct impact on pricing behaviour but may improve quality, increase variety, or increase levels of investment.

The potential sources of efficiency gains from vertical and conglomerate mergers stem from a wide variety of mechanisms and occur in a broad range of situations. However, they can be broadly grouped under four headings.

– *Increasing pricing efficiency*: In many cases, charging a uniform unit price will not be an optimal way of organising a supply chain or of providing complementary products. However, more sophisticated pricing mechanisms may be costly or impossible to introduce. In such cases, by removing the need for external pricing, non-horizontal integration can lead to a more efficient outcome.

– *Increasing productive efficiency*: Non-horizontal integration may result in a more efficient use of inputs or productive assets, due to the existence of economies of scope or scale, improved managerial or financial efficiency, supply assurance or increased buyer power.

– *Preventing profit expropriation*: In some cases, a firm may be unable to appropriate the full benefits of its investments, as these are partly reaped by others in the supply chain. This can result in sub-optimal levels of investment. By "internalising" such externalities, non-horizontal mergers can lead to significant efficiency gains.

– Finally, market transactions may be subject to *transaction costs and incomplete contracts*. Where contracts are not fully specified, a party may be able to exploit contractual loopholes to the disadvantage of their vertical partners. To overcome this problem, costly monitoring or incentive mechanisms may have to be used. In certain situations, such as those that give rise to the so-called "hold-up" problem, investment may be deterred altogether. Furthermore, at a general level, all contractual relationships are subject to transaction costs, such as those incurred in drawing up the contract or searching for an appropriate trading partner. By eliminating such contractual problems, both vertical and conglomerate mergers can give rise to efficiency gains.

Efficiencies are thus an important motive for non-horizontal mergers. In some cases there may be alternative means of achieving these benefits, such as non-linear pricing,

vertical restraints, other contractual obligations, commitment devices, or reputation considerations. However, such mechanisms are not always available, and may give rise to additional costs and problems. In consequence they do not eliminate the power of efficiency rationales as a motive for non-horizontal integration. It should therefore not be surprising that non-horizontally related firms from a wide range of sectors may wish to integrate to at least some extent, in order to realise such gains.

Is the framework for assessing horizontal mergers appropriate for non-horizontal mergers?

The typical approach to assessing horizontal mergers as set out in the EC horizontal merger guidelines divides the analysis into two broad steps. First the potential anti-competitive effects of the merger are examined. Then, where a merger is held to give rise to anti-competitive outcomes, the extent to which efficiencies generated by the merger might offset such concerns is examined.[8] Based on the analysis set out above, it is evident that this two-step approach is both impractical and inappropriate for assessing many of the efficiencies generated by non-horizontal mergers.

The focus of the EC horizontal merger guidelines' assessment of merger efficiencies is on marginal cost savings. The impact of such efficiencies on pricing incentives can be readily assessed independently of any lessening of competition. However, many of the most important efficiencies generated by non-horizontal mergers are the result of synergies arising from the combination of complementary assets rather than reductions in marginal costs. This means that it is difficult to evaluate these efficiencies in isolation and then bolt them on to the main analysis where a merger is otherwise found to be problematic. Indeed, the two-step approach to assessing efficiencies is appropriate if and only if:

- the anti-competitive issues raised by the merger can be assessed separately from the likely efficiency impacts; and
- a direct trade-off can be made (i.e., the efficiency can be readily translated into an impact on pricing incentives in the same terms as the alleged anti-competitive harm).

Not only is it difficult to make a direct trade-off comparison between the pro-competitive efficiency effects and the adverse effects on pricing and/or quality,[9] but in many cases it is simply not possible to assess the potential anti-competitive concerns separately from the pro-competitive effects for the simple reason that the same phenomenon lies at the bottom of both effects. Indeed, in many instances, the theory of competitive harm posited in the appraisal of non-horizontal mergers arises *because* the merger generates an efficiency. For example, in assessing the competitive effects of a merger that is expected to give rise to bundling, the anti-competitive concern (foreclosure of rivals who are not able to bundle) has the same source as the pro-competitive benefits (the elimination of pricing inefficiencies). This implies that for many types of efficiency generated by non-horizontal mergers, the assessment of efficiencies necessarily forms part of an integrated and unified competitive assessment.[10]

In all such cases, an analytical framework can be advanced for assessing the competitive effects of the non-horizontal merger. Our suggested framework has four conditions which need to be present in order for the transaction to lead to anti-competitive exclusionary effects. These conditions are as follows:[11]

- *Condition A: Existence of significant market power*. Pre merger, at least one of the merging parties has significant market power in at least one relevant market. It is commonly accepted that where firms do not possess significant market power, their actions cannot give rise to anti-competitive outcomes.

8 It should be stressed that in practice this approach to assessing the competitive effects of a horizontal merger is only appropriate for (a) assessing unilateral effects concerns and (b) only applies to marginal cost efficiencies.

9 For example, how can one translate the efficiency generated by combining complementary assets into an impact on pricing incentives?

10 Paradoxically, in such cases, the more modest the efficiency the less likely it is that the marginalisation of competitors will take place.

11 This analytical framework applies to the assessment of potential exclusionary strategies, which are generally the main concern in non-horizontal merger cases. This framework is based on the analysis undertaken by RBB Economics on behalf of General Electric in its acquisition of Amersham. This analysis was incorporated directly into the Commission's Phase I clearance decision.

- *Condition B: Rival firms are unable to respond.* Rival suppliers to the merging parties will find it impractical to respond by adopting a similar strategy.[12] To the extent that rivals are able to adopt similar strategies either by merging with other firms or by their own teaming arrangements, the competitive advantages of the hypothesised strategy (e.g. bundling) will be to a large extent mitigated.
- *Condition C: Competitors are marginalised.* As a result of the merger, competing suppliers will lose volumes to the merged party and as a result are marginalised. However, it is important to be clear as to what is meant by the marginalization of competitors. All price reductions 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, such price decreases do not generally harm competition. A price reduction can be said to marginalise competitors only if, at any given price level, the competitive constraint currently provided by rivals at that price level would be reduced following a temporary price reduction.
- *Condition D: Competition is adversely affected in the long run.* As a result of the above chain of events, competition is adversely affected in the long run. In consequence, prices will increase and customer interests will be harmed. This can only occur if competitors are marginalised to such an extent that there is a tangible adverse effect on competitive rivalry that harms consumers in the long term.[13] Moreover, it is important to take into account how long it takes to get to the "long run". The longer it takes for any long run adverse effects to arise, the less likely it is that the merger will be anti-competitive.[14]

Conclusion

The central message from the above discussion is that there should be an economic presumption that non-horizontal mergers are pro-competitive. This conclusion derives from a fundamental difference between horizontal and non-horizontal mergers. Whereas horizontal mergers remove a direct competitive constraint and raise the possibility that post-merger prices will increase to the detriment of consumers, non-horizontal mergers do not. Moreover, the general impact of a non-horizontal merger is to reduce prices as a result of eliminating externalities and other inefficiencies that might have existed pre-merger. While this is not to say that non-horizontal mergers are always pro-competitive, it does indicate an economic presumption (albeit rebuttable) that such mergers are competitively benign.[15] We would very much hope to see this view reflected in the forthcoming non-horizontal merger guidelines.

This economic presumption has important implications for the assessment of non-horizontal mergers that do contain the potential for anti-competitive effects. In the competitive assessment of those commercial strategies that might give rise to both efficiencies and potential anti-competitive concerns, it should be assumed that the pro-competitive effects predominate, i.e. any efficiency generated by a non-horizontal merger is deemed to give rise to pro-competitive outcomes, *unless* it can be demonstrated otherwise. This is in marked contrast to the approach periodically adopted hitherto, often labelled the *efficiency offence*, whereby efficiencies tend to be viewed as inherently problematic.

12 I.e., a commercial strategy that gives rise to competitive concerns, but that may also generate significant efficiencies (see above).

13 This virtually requires that the firm's competitors are eliminated from the market. Competition could also be harmed if it could be shown that marginalisation had the effect of permanently reducing investment in new products, but this is likely to be extremely difficult to prove in practice.

14 This is true for two reasons. First, since consumers benefit until the long run adverse effects materialise, it is more likely that the short run benefits will outweigh the long run detriment. Second, it becomes harder to meet the standard set out by the European Court of Justice in its Tetra Laval judgment which specified the need for convincing economic evidence to support chains of predictions that are "uncertain and difficult to establish" (see Judgment of the Court in case C-12/03 P, 15 February 2005, paragraph 44). Intuitively, this uncertainty is bound to increase considerably as the time frame of the analysis is pushed further into the future.

15 This *economic* presumption does not necessarily imply a *legal* presumption. Nonetheless, it entails that compelling evidence will be required to establish that the merger leads to a significant impediment of effective competition.