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Seeing vertical mergers through a different lens? Implications from EssilorLuxottica/GrandVision

Introduction

In recent years, some commentators have called for more enforcement in vertical mergers, arguing that these have a greater potential to be anticompetitive than has historically been presumed.[1] They have highlighted the need to assess "less extreme" theories of harm, which do not necessarily imply a refusal to deal with downstream or upstream competitors. They have noted in particular the need to assess the effects of vertical mergers on pricing incentives, following the same logic that is applied to the assessment of unilateral effects in horizontal mergers.

In 2021, the European Commission concluded its in-depth review of *EssilorLuxottica/GrandVision*, in which it effectively adopted this view.[2] Contrary to previous recent vertical mergers, the Commission's concerns did not entail a possible refusal to supply downstream rivals; rather, its concerns were exclusively focused on the change in pricing incentives that the merger could bring about.[3] Importantly, the Commission assessed these possible effects by relying for the first time on vGUPPIs, a theoretical model that extends the principles of Upward Pricing Pressure ("UPP") tests for use in vertical merger settings. The model played a central role in the Commission's assessment.[4]

This Brief discusses the Commission's assessment of *EssilorLuxottica/GrandVision* and its possible implications for future vertical merger investigations. We explain that vertical mergers can give merging parties an incentive to raise prices, and that the Commission should seek to assess this theory of harm in cases.[5] Crucially, we argue that such assessment should not be confined to a superficial application of price pressure tests, in particular where such models fail to predict pre-merger outcomes or generate harmful results only under assumptions that are not reflective of the industry and firms at issue. We argue that more weight should be given to the empirical assessment of available market evidence.

The potential price effects of a vertical merger

In *EssilorLuxottica/GrandVision*, the Commission analysed the acquisition of GrandVision ("GV"), a retailer of optical products (opticians), by EssilorLuxottica ("EL"), a wholesale supplier of eyewear and ophthalmic lenses. The Commission's investigation focused on EL's successful eyewear brands (such as Ray-Ban, Oakley and Persol), and on whether these brands could, post-merger, be used by EL to reduce the competitiveness of GV's rivals (other opticians).[6]

The Commission effectively ruled out *total* input foreclosure concerns at a relatively early stage of the investigation, accepting that EL heavily relied on GV's rivals to bring its products to market, and that therefore EL would have strong incentives to continue trading with them post-transaction.[7,8] Instead, the Commission focused on the scope for the transaction to give rise to price increases due to changes in pricing incentives.[9] Two main price effects were considered in this context.

1. **An increase in the wholesale prices EL charges to rival opticians.** The Commission considered that, by increasing prices of important eyewear brands to downstream rivals, EL could reduce their competitiveness and generate demand diversion towards GV's retail stores. This would lead to the merged entity obtaining the retail margin associated with these sales. This theory of harm is commonly known as "partial input foreclosure".
2. **A change in the retail prices GV charges to final consumers.** The Commission considered two (opposed) ways in which GV's pricing incentives downstream could be affected by the merger, which we outline below.

1 These calls have notably emerged in the context of the review of the US vertical merger guidelines. For example, see Jonathan B. Baker, Nancy L. Rose, Steven C. Salop & Fiona Scott Morton, *Five Principles for Vertical Merger Enforcement Policy*, Antitrust, Summer 2019, at 12-17, and Steven C. Salop, *Invigorating Vertical Merger Enforcement*, 127 Yale Law Journal 1962-1994 (2018).

2 Case M.9569 – *EssilorLuxottica/GrandVision* (2021). RBB Economics advised EssilorLuxottica throughout the investigation.

3 Whilst partial input foreclosure as a theory of harm is not novel, historically it has only been found as leading to competition concerns in conjunction with total input foreclosure. See, for example, Case No COMP/M.9064 – *Telia/Bonnier* (2019). In some past cases, notably Case No COMP/M.4854 - *TomTom/TeleAtlas* and Case No COMP/M.4942 - *Nokia/NAVTEQ*, the concern was assessed on a standalone basis but was ultimately dropped.

4 In recent years, a number of other competition authorities have started using vGUPPIs, including the CMA in the UK (see *Tesco/Booker* and *Co-op/Nisa*).

5 See NHMG, para. 33, for example.

6 In two EEA countries (Italy and the UK), where EL already had a retail network, the Commission also conducted a horizontal analysis. These horizontal issues are outside the scope of this Brief.

7 Using a vertical arithmetic model, the Parties submitted that total input foreclosure would only be profitable for (very) high levels of customer switching from foreclosed retail competitors to GV. Such levels of customer switching were considered unlikely to occur in reality.

a. *Elimination of double mark-ups*. First, GV could have an incentive to decrease its retail prices, as the merged entity would now take into account that by reducing price and selling more units downstream, it would *also* earn the upstream margin associated with such further sales. This is the so-called elimination of double mark-ups, or "EDM", which is recognised in the Commission's Non-Horizontal Merger Guidelines (henceforth, "NHMG").[10]

b. *Diagonal effects*. *Second*, GV could also have an incentive to increase retail prices downstream through a form of "diagonal" effect. This could arise because post-merger, following a retail price increase, the eyewear sales lost to other retailers would also generate wholesale margins for EL; in other words, for GV, losing sales to rivals would be "less costly" than before, and this could give GV an incentive to increase its optimal retail price.[11]

   The net impact on GV's pricing would depend on the interplay between these two opposing effects.

What role for vGUPPIs?

To measure these price effects, the Commission heavily relied on *vertical Gross Upwards Pricing Pressure Indices*, or "vGUPPIs".[12] vGUPPIs adapt the core principles of UPP models for use in vertical merger settings. vGUPPIs separately provide estimates of the two main price effects mentioned above.[13] In particular:

- The **vGUPPIu** provides an estimate of the effect on upstream pricing incentives (the wholesale of eyewear by EL in this case), and
- The **vGUPPId** provides an estimate of the effect on downstream pricing incentives (the retail of eyewear by GV).[14]

UPP analyses are simplified tools, based on a highly stylised view of competitive interaction. They require only a small number of pre-merger data points (mostly gross margins, diversion ratios, and churn rates). Importantly, they are inherently static and ignore offsetting factors such as the entry or repositioning of competitors.

Although UPP-type analyses were originally devised as screening tools to be used at early stages of an investigation (to rule out concerns), in practice they have been used by the Commission in merger decisions to support conclusions that a Significant Impediment of Effective Competition ("SIEC") is likely.[15] Indeed, the Commission's reliance on UPP models was heavily criticised in the recent General Court annulment of its *Three/O2* decision.[16] The Court went as far as concluding that such models do not have probative value, and are therefore not sufficient to show that a SIEC is likely.[17]

In EL/GV, the Commission's decision effectively put forward vGUPPIs as the core economic analysis supporting a SIEC finding. The Parties argued that the Commission's use of UPP analyses in this case was more problematic than in past cases, mainly for two reasons. First, the Commission extended the use of UPP models to a vertical theory of harm, i.e., more complex and indirect than the approach already deemed by the General Court to be non-probative.[18] Second, the assumptions of the model on the absence of dynamic rival responses (i.e. no entry or repositioning by rivals) are less reflective of market reality in the retail and wholesale of eyewear than the telecoms market, which was the only other industry where the Commission had used UPP analysis.[19]

Apart from the conceptual disagreement on the use of vGUPPIs, the Parties also disagreed with the Commission on how these tools were implemented in practice and the weight given to their results relative to other evidence available. We turn to this in what follows, discussing first the Commission's vGUPPIu (wholesale price increases) and then its vGUPPId (retail price increases).

Testing vGUPPIu against the facts: back to *Tetra*?

In the early 2000s, the Commission's overreliance on theoretical considerations in its assessment of non-horizontal mergers resulted in the General Court finding that it had not gone far enough in testing its theories against industry facts. These criticisms underlay the Court's annulment of the Commission's non-horizontal assessments in *Tetra Laval/Sidel* and *General Electric/Honeywell*, which led to an overhaul of the Commission's approach to non-horizontal mergers and to the publication of the NHMG in 2008.[20] These judgements made it a prerequisite that economic models need to be supported by the realities of the industry in consideration.

8 The Commission also considered, but ultimately dropped, customer foreclosure risks whereby GV would stop purchasing from rival lens manufacturers.

9 Here and through this Brief, increases in price can also be thought of as decreases in quality.

10 NHMG, paras. 13 and 55, for example.

11 This can be thought of as if GV acquired an interest (a share) in all its rivals that are served by EL. This effect, while representing a theoretical possibility, has normally been ignored by the Commission in past cases, and is not even contemplated in the NHMG.

12 S. Moresi and C. Salop (2013), 'vGUPPI: Scoring Unilateral Pricing Incentives in Vertical Mergers', Antitrust Law Journal, 79(1), 187–214.

13 Technically, vGUPPIs seek to reflect the increase in the opportunity cost of selling that the firm faces as a result of the transaction. On this logic, for example, selling eyewear to downstream rivals would become more "costly" post-merger, as by selling to them the company loses the opportunity of (with a certain probability) selling those units at its own retail stores downstream.

14 vGUPPI models also provide an estimated price increase for rival retailers, known as the "vGUPPIr". This price effect, however, follows from the putative wholesale price increase (the vGUPPIu) and we ignore it here for simplicity.

15 See Farrell, J. and Shapiro, C. (2010). *Antitrust Evaluation of Horizontal Mergers: An Economic Alternative to Market Definition*. The B.E. Journal of Theoretical Economics, 10(1).

16 EU General Court, T-399/16 — *CK Telecoms UK Investments v Commission*, 2020 (the "Hutchison judgement").

17 Hutchison judgement, paragraph 268. The judgment is currently under appeal.

As noted above, in EL/GV, the Commission's vGUPPIu analysis predicted wholesale price increases on the part of EL. Importantly, the merging parties argued that the available market evidence was inconsistent with these results. More specifically:

- EL showed that despite already having a retail footprint in Europe and other parts of the world, it had never increased prices to rival opticians. More specifically, EL showed that in those countries where it already had a retail network (e.g. Italy, the UK, the US), the firm did not charge higher prices to those rival retailers that were located closer to its own stores. It also showed that following its previous acquisition of Salmoiraghi & Viganò, a significant optical retail chain in Italy, the firm had not increased wholesale prices in Italy compared to other countries. EL argued that the Commission's own vGUPPIu model would have predicted a significant price increase for these prior acquisitions, and that if the model was unable to successfully explain the past, it should not be relied upon to predict the future.[21]
- EL also highlighted that the Commission had gathered and reviewed thousands of internal documents from the company and that it had not found any supporting its theory of harm, consistent with the firm's open business model.

The Commission dismissed this evidence on the basis that EL's presence in retail overall would be much larger following the acquisition of GV, and that this could trigger the materialisation of incentives that had not taken effect before.

While it is common for the Commission and merging parties to disagree on the relevance of a point of evidence, the Commission's assessment in this case raises a much more fundamental question: is it sufficient for the Commission to dismiss market evidence that *contradicts* its theory of harm? Should not the Commission be required to gather market evidence that *supports* it? Putting forward confirming market evidence should be a prerequisite for intervention in merger control in general, but even more so in the context of non-horizontal theories of harm, where more conditions need to be fulfilled for anti-competitive effects to materialise.

vGUPPId and increased self-supply: a mischaracterisation of pro-competitive effects?

The Commission's analysis of downstream price increases (vGUPPId) provides a further example of the need to consider the predictions of theoretical economic models carefully, and to sense-check whether they are oversimplifying market dynamics or mischaracterising effects.

As discussed further above, there are two potential ways in which the retail prices GV charges to final consumers could be affected by the merger: (i) an incentive to *lower* price due to the elimination of double mark-ups (or "EDM"), and (ii) an incentive to *increase* price due to the fact that part of the sales lost to rival retailers would now be "recouped" in the form of EL margins upstream (a "diagonal" effect). The net effect is captured in the vGUPPId index.

In most contexts, the former effect will more than offset the latter, and the net impact (a price *decrease*) will be positive for consumers and competition.[22] In EL/GV, however, the Commission's vGUPPId analysis suggested that there would be a net *increase* in retail prices. This was driven by the fact that pre-merger GV sold substantially *less* EL products than the average rival retailer. According to the Commission, the fact that GV purchased less from EL meant that, compared to other vertical mergers, the scope for double margins to be eliminated (EDM) would be smaller. Moreover, this difference in product mix between GV and its rival opticians also meant that the incentive for GV to raise its price downstream would be stronger, as rivals procure *more* from EL and therefore the extent of recoupment by the integrated company when GV raises price is larger.

The Commission's prediction of retail price increases in this context was therefore based on the logic that – compared to a standard vertical merger – GV would have a stronger incentive to generate demand diversion towards rival stores, as in such rival stores the probability that a consumer purchases an EL product would be higher.

The Parties found this logic to be problematic, mainly for two reasons.

- First, the Parties argued that by assuming product mixes as fixed, the vGUPPI model was effectively mischaracterising a (pro-competitive) increase of self-supply as an (anti-competitive) price increase. This is because engaging in the pricing strategy mentioned above would be evidently inferior to increasing self-supply of EL products at GV's stores. Indeed, by simply increasing prices at GV (as posited by the Commission), the integrated company would forego the *retail* margin associated with customers that switch to rival retailers, whilst by increasing the presence of EL products at GV stores, the company would retain such margin.

18 These difficulties arise because, relative to horizontal mergers, changes to firms' unilateral pricing incentives under partial input foreclosure are more complex and indirect. Whereas in a horizontal setting a price increase by one of the parties leads to gains to the other party through customer diversion, in a vertical setting this link also critically depends on the strategic reactions of downstream rivals, and the extent to which they can replace the Parties' upstream products by others.

19 In the eyewear industry, there are many recent examples of entry and repositioning both by eyewear brands (upstream) and by optical retailers (downstream).

20 For example, see Case T-5/02, *Tetra Laval BV v Commission*, Judgement of the Court of First Instance, 25 October 2002, paragraph 155; or Case T-210/01, *General Electric vs Commission*, Judgement of the Court of First Instance, 14 December 2005, paragraph 462.

21 There is an important difference between total input foreclosure (a refusal to supply) and partial input foreclosure (a wholesale price increase). The former is an extreme strategy where incentives for it either exist or do not, and where the addition of further footprint downstream may indeed act as a "trigger" and give rise to a practice or effect that did not exist at all pre-merger. Partial input foreclosure is a much more "gradual" practice, reflecting a change in incentives that largely depends on the increment being acquired, and where therefore evidence on past acquisitions is particularly relevant to the analysis.

22 Generally speaking, the "diagonal effect" can dominate EDM if specific conditions are met, which are that downstream demand is highly inelastic (i.e. a decrease in downstream price would not increase the total volume sold) and either (i) the upstream entity is a monopolist (or has an exceptionally high market share), or (ii) the downstream entity relies relatively little on the upstream entity's supply and this cannot be increased significantly post-merger. In these cases, a price reduction from the downstream entity would not result in an increase of sales for the upstream entity (and may even decrease the latter's sales).

Importantly, by increasing self-supply, double mark-ups are eliminated relative to the counterfactual, which is pro-competitive. To illustrate the relevance of this point, consider the following example. Consider a merger between a wholesale supplier of petrol (upstream) and a petrol station (downstream), and that pre-merger the petrol station happens to purchase its petrol from *another* wholesale supplier. According to the Commission's model, this transaction would give the petrol station an incentive to increase prices (to the detriment of consumers), as this would increase the sales of rival stations which do purchase from the integrated company upstream. However, post-merger, the petrol station will in fact have an incentive to procure its petrol internally. As a result of this self-supply, the petrol station will be buying its petrol at cost, which will give it an incentive to decrease prices (double mark-ups are eliminated relative to pre-merger). Indeed, vertical mergers can generate a pro-competitive incentive to increase self-supply, and this is to be promoted, rather than prohibited, by competition authorities.

- Second, the Parties also argued that, irrespective of the *form* that this effect would take (a price increase or an increase of self-supply), its *magnitude* was being overstated. The Commission's model effectively assumed that optical retail products were homogenous (all brands and products competed equally closely), and that therefore there would be substantial switching between non-EL eyewear sold by GV and EL eyewear sold by other opticians.[23] In practice, however, the majority of non-EL eyewear sold by GV was private label, which cost a fraction of EL's brands and targeted a different customer segment.

A need for structural remedies

After many discussions with the Parties, the Commission maintained its concerns in three countries (Belgium, the Netherlands, and Italy).[24] Unlike past vertical mergers, the Commission did not accept behavioural commitments to remedy concerns. This was because in this case, its concerns did not relate to a refusal to supply but to effects on price, and the wide variety and regular renewal of EL's eyewear products meant that a behavioural commitment on price levels would have been harder to design and monitor.[25]

EL ultimately agreed to a structural divestment of stores in these three countries. It is worth noting, however, that the magnitude of the remedy package was relatively contained (between 15% and 40% of the stores being acquired in the three countries, and about 6-7% in Europe as a whole).

Conclusions

Historically, the Commission's assessment of vertical mergers has focused on more extreme forms of foreclosure, notably total input foreclosure (a refusal to supply downstream rivals). The Commission's assessment of EL/GV, however, was entirely focused on a much more gradual theory of harm, related to the changes in pricing incentives that the merger could bring about. Such changes in pricing incentives were measured with vertical price pressure tests. This may mark a change in how the Commission approaches certain vertical mergers in the future, and is likely to lead to more intervention.

Vertical mergers can give merging parties an incentive to raise prices, and the Commission should seek to assess this in cases. However, the mechanisms through which these price increases can emerge are indirect and involve several layers of cause and effect. Their assessment should therefore not be limited to the application of theoretical models, in particular where these models are unable to explain current market outcomes or they mischaracterise important features of the industry and firms under analysis. The empirical assessment of market evidence should be given a more important role in the investigation, and should be required to test and confirm any theoretical predictions.

23 This was inconsistent with the Commission's own assessment of the eyewear market upstream, where it highlighted the importance of brands and the extent of differentiation between the various market players.

24 In the case of Italy, this was combined with horizontal concerns at the retail level, due to the retail presence that EL already had in the country. See Footnote 6 above.

25 The Commission normally refuses to accept commitments involving price control. In *Telia/Bonnier*, the Commission did accept behavioural commitments to remedy price concerns, but there the product at issue was effectively only one, and it was sold via long-term contracts. Current conditions could be easily extended over a number of years.