



Competition Competence Report 22/ 2007

## ECONOMIC ASSESSMENT OF NON-HORIZONTAL MERGERS – GUIDELINES OF THE EUROPEAN COMMISSION

Recently the European Commission (EC) published draft guidelines on the assessment of non-horizontal mergers. Following the public consultation, the guidelines will be adopted by the EC. The non-horizontal guidelines intend to complement the existing guidelines on horizontal mergers and are supposed to come into force in 2007.

The non-horizontal guidelines are a further, consistent implementation of the “more-economics-based-approach”. Whereas the justification of the “more-economics-based-approach” itself is not questioned anymore, the correct implementation of the “more-economics-based-approach” is still an issue. “The drawing up of these Guidelines shows once more the Commission’s commitment to providing clear and predictable guidance for businesses”, said Competition Commissioner Kroes.

This CCR illustrates the implementation of the “more-economic-based-approach” in the non-horizontal guidelines by dealing with the economic analyses of the effects of non-horizontal mergers on competition. First, the main statements of the EC in their draft guidelines are discussed, before the approach the EC intends to follow is described. Subsequently, several economic methods for analysing non-horizontal mergers EE&MC uses in practice are illustrated.

### MAIN STATEMENTS IN THE DRAFT GUIDELINES OF THE EUROPEAN COMMISSION

The draft guidelines made some important statements which are reviewed in the following:

**Definition:** Two broad types of non-horizontal mergers can be distinguished: vertical mergers and conglomerate mergers. The EC defines vertical mergers as mergers that involve

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companies operating at different levels of the supply chain. Conglomerate mergers are mergers between firms that are in a relationship that is neither purely horizontal nor vertical.

**Effects:** Based on fundamental principles of competition theory and economic effects, non-horizontal mergers are less likely to raise competition concerns than horizontal mergers. Unlike horizontal mergers, vertical or conglomerate mergers do not entail the loss of direct competition between merging firms in the same relevant market. The main source of anti-competitive effects is absent. Thus, non-horizontal mergers should only be prohibited if massive anti-competitive effects can be proven.

**Efficiencies:** The EC emphasises in its draft guidelines explicitly the consideration of efficiencies. This progress is in line with economic literature and is – from the competition economics point of view – welcomed: in particular vertical mergers can give rise to considerably efficiencies and may enhance consumer welfare (e.g. because of elimination of double-marginalisation or a decrease of transaction costs and so on). Efficiencies could outweigh anti-competitive effects of non-horizontal mergers.

**Safe harbour:** In their draft, the EC assumes that concerns are less likely with non-horizontal mergers, when the post-merger market share of the new entity in each of the markets concerned is below 30%. Thus, firms with low markets shares are in a so-called safe-harbour. In fact, the market share of 30% could be increased since the anti-competitive effects of non-horizontal mergers are in most cases insignificant. In the US, non-horizontal mergers scarcely are assessed at all.

**Non-coordinated effects:** The EC states that there are two main ways in which non-horizontal mergers may significantly impede effective competition: non-coordinated effects and coordinated effects. Non-coordinated effects may arise when non-horizontal mergers give rise to foreclosure: the merger may grant the merging firms the ability to foreclose the rival firms' access to supplies or markets. Two modes of

foreclosure can be distinguished: "input foreclosure" and "customer foreclosure".<sup>1</sup>

"Input foreclosure" may arise e.g. if a paper producer with market power merges with a printing plant and - after the merger - rivaling printing plants can purchase paper only at bad conditions, higher prices or not at all. The "new" rivals would need to purchase the paper somewhere at higher prices and would not be able anymore to sell their products (e.g. books) at competitive prices. This would in turn allow the merged entity to raise their prices to the detriment of the customers.

**Coordinated Effects:** Coordinated effects arise where the merger changes the nature of competition in such a way that firms that previously were not coordinating their behaviour might change their view: coordination might be more likely, prices might increase or effective competition might be harmed in another way. Both conglomerate and vertical mergers can facilitate anti-competitive concerted practices. Thus, depending on the market circumstances coordination is easier to achieve when the number of market participants is reduced (e.g. due to the foreclosure of competitors).

### THREE-STEP-ANALYSIS OF THE EUROPEAN COMMISSION

The EC developed a three-step-approach to analyse non-coordinated effects of non-horizontal mergers. This approach is applied in the following to "input foreclosure". In assessing the likelihood of anti-competitive "input foreclosure" the EC will examine three questions:

- First, whether the merged entity would have, post-merger, the ability to substantially foreclose access to inputs?
- Second, whether it would have the incentive to do so?

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<sup>1</sup> „Input foreclsoure“, is where the merger is likely to raise the costs of the downstream rivals by restricting their access to an important input. Customer foreclosure means the restriction of the access of upstream rivals to a sufficient customer base.  
Regarding conglomerate mergers foreclosure is less likely, but could arise in same circumstances due to tying and bundling. Market power is a main condition. (see in detail CCR Nr. 12 und 13).

- Third, whether a foreclosure strategy would have a significant detrimental effect on competition?

In the first step, the ability of the merged entity to foreclose the market by considering all different modes of foreclosure like raising prices, restricting supplies or a more subtle mode like degrading the quality of inputs supplied is analysed.

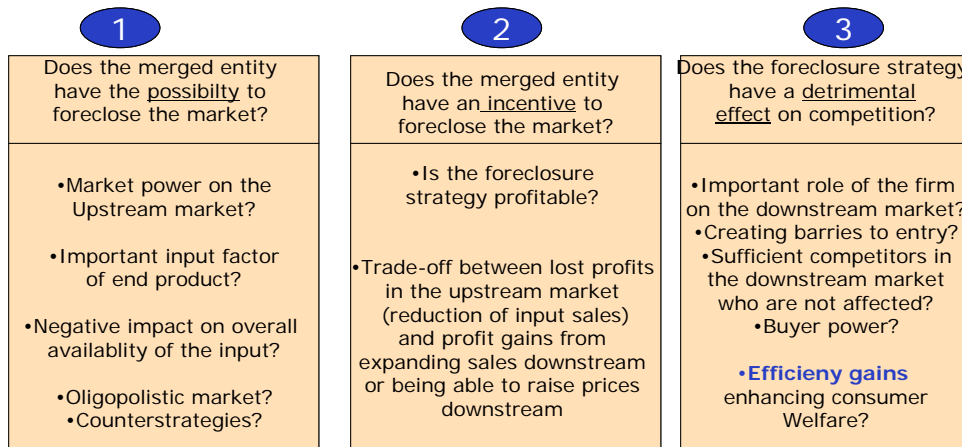
In the second step, it is assessed whether the merged entity has an incentive to foreclose access to inputs. This incentive depends on the degree to which foreclosure would be profitable. In addition, since the adoption of a specific course of conduct by the merged entity is an essential element in the assessment of foreclosure, the factors liable to reduce, or even eliminate, those incentives, are examined including the possibility that the conduct is unlawful under Article 82 EC-Treaty.

In the third step, the effects on competition are analysed and anti-competitive and pro-competitive effects are balanced: anti-competitive "input foreclosure" e.g. may occur when a vertical merger allows the merging parties to increase the costs of downstream rivals thereby leading to an upward pressure on their sales prices. The higher the proportion of rivals which would be foreclosed on the downstream market, the more likely the merger can be expected to result in a significant price increase in the downstream market and thus significantly impede competition.

Subsequently, efficiencies are considered. Efficiencies may outweigh anti-competitive effects, if the efficiencies generated by the merger are likely to enhance the ability and incentive of the merged entity to act pro-competitively for the benefit of consumers.

The following chart illustrates these three steps.

*Chart 1: Three-step-approach: example "input-foreclosure"*



## ECONOMIC METHODS FOR ANALYSING NON-HORIZONTAL MERGERS

In economic theory, the effects of non-horizontal mergers on competition, in particular the efficiency gains are discussed broadly. Complex theoretical models have been developed in this context. However, the practical application of empirical models is missing in non-horizontal merger investigations.

EE&MC thus presents in the following economic methods, which can be used to assess the effects of non-horizontal mergers. Since EE&MC contributed to the development of the draft guidelines, the EE&MC approach meets the approach laid down in the draft guidelines.

### ECONOMIC ANALYSIS OF THE MARKET CONTEXT

First, the assessment of the market context and the identification of the market position of the firms involved are important. E.g. with respect to "input foreclosure", the ability to foreclose depends whether an important input for the downstream product is concerned, whether the input concerned represents a significant cost factor relative to the price of the downstream product and if there alternatives to purchase the input. The purchase alternatives are worse if the merged entity has a strong market position on the upstream market. Thus, for "input foreclosure" to be a concern, the vertical merger must involve a company that has market power in the upstream market.

EE&MC performs first of all an in-depth market-structure-analysis that contains among others the following elements:

- definition of the relevant product and geographic markets,
- calculation of the market shares of the firms concerned on upstream and downstream markets,
- development of markets shares over time,
- analysis of actual competitors,
- assessment of product characteristics and value chains.

If sufficient downstream competitors would remain whose costs are not raised due to the merger because they are themselves vertical integrated or they are capable of switching to alternative inputs, competition from those firms may constitute a sufficient competitive constraint on the merged entity.

Moreover, the assessments of potential competitors and of market entry barriers play an important role: sufficient markets entries on the upstream market could for example render a foreclosure strategy ineffective because the downstream rivals can switch the supplier. Therefore, EE&MC analyses whether legal, structural or strategic entry barriers exist and which modes of market entry are likely.

### COST-BENEFIT-ANALYSIS

By means of cost-benefit-analysis, profitability and thus the incentive for foreclosure strategies can be examined. The likelihood of foreclosure can be identified. In the following, this method is described taking "input foreclosure" as an example: if a vertical-integrated paper producer forecloses the market against other printing plants on the downstream markets by refusing supply, the costs of such a strategy would be the lost upstream margin on wholesale sales. The benefits would in turn arise from the weakened downstream competition from rivals, who are no longer able to sell at competitive prices. Thus, the own integrated printing plant could increase sales and profits.

Essentially, the merged entity faces a trade-off between the profit lost in the upstream market due to a reduction of input sales to (actual or potential) rivals and the profit gain from expanding sales downstream or, as the case may be, being able to raise price in that market. The trade-off is likely to depend on the level of profits the merged entity obtains upstream and downstream. The lower the margins upstream, the lower the loss from restricting input sales. Similarly, the higher the downstream margins, the higher the profit gain from increasing market share downstream at the expense of foreclosed rivals.

With economic cost-benefit-analysis the concrete costs/benefits of a foreclosure strategy can be calculated. Exceed the costs the benefits the implementation of a foreclosure strategy is not rational from an economics point of view.

Thus, EE&MC can prove empirically, that a foreclosure strategy following non-horizontal mergers is a) likely or b) irrational and unlikely.

### GAME THEORY

The appearance of market coordination can be analysed with the support of game theory: Game theory and its requirements (agreement, monitoring, and punishment) suit for the analysis of coordinated effects. After Airtours/First Choice, the Court of First Instance recently confirmed

the application of game theory again and discussed the requirements of economic analysis in Sony/BMG.

Game theory can answer the question which market outcome is likely in an oligopoly by assessing mainly three conditions:

- First, if the coordinating firms can monitor to a sufficient degree whether the terms of coordination are being adhered to;
- Second, if there is a credible deterrent mechanism;
- Third, the reactions of outsiders.

Besides an analytical evaluation of the facts, econometric merger modelling is required to forecast the behaviour post-merger. Special merger simulation models that are adjusted to the game-theoretic questions are suitable. (see also CCR Nr. 1 und Nr. 19).

## EE&MC-COMPETENCE

EE&MC has extensive experiences with the assessment of horizontal, vertical and conglomerate mergers. While analysing non-horizontal mergers, different econometric tools are applied - always adapted to the specific situation of the case to reach optimal results. EE&MC expert reports proved to be highly accepted on national level as well as with the EC and courts. Economic consulting by EE&MC is an effective means to assure and speed up the approval procedure and to achieve a fast approval of vertical and conglomerate mergers without undertakings.