Non-Horizontal Mergers Guidelines: Ten Principles

A Note by the EAGCP Merger Sub-Group

The Directorate General of Competition is contemplating the introduction of Non Horizontal Merger (NHM) Guidelines.[1] Given the state of the art on the accumulated knowledge about NHM, we are skeptical about the possibility of drafting detailed NHM guidelines which are comparable in terms of operational content to the Horizontal Merger Guidelines. At the same time, some guidance about the way competition authorities in the EU approach NHM would be very useful. In this perspective, the purpose of this note- is to propose a set of robust economic principles that, we believe, are important for reviewing NHM and framing eventual guidelines.

The first five principles highlight key economic differences between horizontal mergers and NHM. These distinctions have a significant impact on how non-horizontal mergers should be reviewed by DG Competition. The second five principles relate to what the guidelines should achieve.

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[1] We have had access to a draft of proposed Guidelines by the DG-Competition on April 2006. However, the present document is written as a set of stand-alone principles.

1. The competitive impact of non-horizontal mergers is fundamentally different from that of horizontal mergers.

With horizontal overlaps, the parties pre-merger will place pricing constraints on each other if they have market power. A horizontal merger will remove this competitive restraint. The clear presumption in a horizontal merger is, therefore, that it will directly lead to increased market power and higher prices (or, at least, to an ability to raise prices). This is not the clear presumption for a non-horizontal merger.[2] While horizontal mergers entails merger among substitutes, non-horizontal mergers involve mergers between complements which might enhance efficiency. This principle is backed both by economic theory and some empirical evidence. The competitive effects of non-horizontal mergers will depend on characteristics of the situation examined.

2. The sources of competitive harm in non-horizontal mergers often require a change in strategy and the impact on competition is indirect.

The competitive harm from a horizontal merger can typically be characterised by its direct impact on the incentive to raise price. In contrast, potential competitive harm in non-horizontal mergers may arise through a change in supply or procurement policy, or the way in which a product range is offered to consumers. These can indirectly affect the cost or demand of rival firms, and so their pricing, ultimately having an impact on consumers.[3] Such indirect effects can certainly impede effective competition, but they do require a particularly careful analysis in order to justify a likelihood of harm.

[2] An additional issue is relevant to the change of competitive conditions resulting from a merger. Non-horizontal merging parties often have some previous contractual relationship, for example that limits buyer or supplier switching, in which case the competitive change following a merger will be muted; whereas parties to a horizontal merger tend not to have prior contracts.

[3] After a vertical merger, the new entity could have the incentive to soften price competition in the downstream market in order to protect its upstream profits, i.e., to keep or attract other downstream firms which need to buy, or to have access, to its (their) upstream products. In this case, the vertical merger can be harmful to final consumers. Note that downstream firms have no reasons to complain about such a situation.

3. There are many forms of non-horizontal merger so there is a large variety of ways in which different (competitive and anti-competitive) effects may occur.

There is no generally agreed set of 'canonical models' of competitive harm to provide guidance for non-horizontal mergers; whereas there is for horizontal mergers (e.g., Bertrand for pricing with differentiated products or Cournot for capacity constrained homogeneous products, and repeated games for coordinated effects). However, there are canonical models of 'no harm' for NHM which are collectively known as those of the Chicago School. Importantly, these state the conditions under which there is no loss of competition due to a non-horizontal merger. In particular, this approach suggests that monopoly profits "can be taken only once" along a vertically linked chain (where, e.g., one of the stages is nearly perfectly competitive), that vertical integration can reduce distortions by eliminating "double marginalization" and that there may be significant production and organization efficiencies as a result of integration. This reasoning (i.e., one source of profit only, and the double marginalization) similarly applies to mergers between complements. The Chicago view turns out to rely on some particular assumptions, but the implication is that the appropriate theory of competitive harm must be particularly carefully "tuned" to the merger in question, specifying the mechanisms through which such harm would be likely to occur. Consequently, guidance should highlight important mechanisms and the way they may combine.

4. Market power in an existing market is an essential pre-requisite for competitive harm from foreclosure.

This is well established by economic research and provides an essential filter for screening out spurious concerns. Furthermore, while market power is a necessary condition for competitive harm from foreclosure, it is not sufficient to expect it. In fact, whenever there is market power at both stages of the vertical chain, in the absence of sophisticated contracts there will typically be double marginalization and therefore the

efficiency gains from vertical integration may be large. Even in the presence of market power, merging firms need not have the incentive to take actions that would reduce the market available to rivals; and even if this is a likely consequence, it need not result in consumer harm.

5. There are stronger efficiency arguments for non-horizontal mergers than for horizontal mergers.

The modern theory of the firm, supported by an increasing body of empirical evidence, informs us that firms as an institution exist due to incomplete contracts and transaction costs, which make it more efficient to carry out certain activities coordinated within a firm as opposed to through markets. If complete contracts could be written (in the sense that they would specify a precise outcome for each possible future contingency) and the associated transaction costs were low, then the need to organize economic activities within firms would be limited. However, such contracts are typically too expensive. The dynamics of the economy mean that the efficient range of activities carried out within a firm may change over time, and mergers can be an appropriate way of achieving an efficiency-enhancing change. The downside of a decision error that wrongly prohibits such mergers, or which requires inappropriate remedies, is likely to be much greater for NHM than for horizontal mergers.

6. Non-Horizontal Merger Guidelines could, in principle, enhance the accuracy and predictability of decisions.

The difficulties inherent in writing detailed guidelines should not be understated. These difficulties are based on the very nature of non-horizontal mergers and the multiplicity of forms that they may take, and are also reflected on the current state of the academic literature. Having a suitable set of principles to deal with NHM is important as they will contribute towards predictability of decisions and consistency. Case handlers

need guidance even if only to point out the difficulties. Predictability is important, especially to businesses and their advisors. Good guidance will be useful for authorities beyond DG Competition.

7. Guidelines should have a clear focus on competitive effects resulting in consumer benefit or harm and not on harm to competitors.

Non-horizontal mergers can create efficiencies, which could lead to competitors losing market share as the merging parties reduce price or provide a more attractive product offering to consumers. This is to be welcomed as consumer benefit. The same applies to the elimination of double marginalization (i.e., the merger of firms with existing market power at successive stages of production, or in complementary products, can create an incentive for them to reduce customer prices). However, there is not always a double margin to be eliminated, even in the presence of imperfect competition, because legally separate parties have an incentive to contract around this source of inefficiency.[4] Thus, pre-merger contracts are very relevant and important in this context. It is particularly important to recognise the benefits of anticipated customer price reductions because competitors anticipating lost market share have a strong incentive to complain loudly to the Commission. An expectation of consumer harm needs very careful support, unless the exit of an efficient competitor is expected.

8. Guidelines should indicate the methodology of analysis and how evidence can be used to indicate the harm resulting from a non-horizontal merger;

This entails establishing both the ability and incentive for merging firms to exploit their new portfolio of activities in a way that would be harmful for consumers. Each

[4] Further, depending on the particular type of market structure under investigation studies, double marginalization does not necessarily reduce the profits of the firms involved (e.g., in certain vertically-linked oligopoly structures, linear pricing and the implied double marginalization help sustain final prices that are higher than the final prices that would be implied under alternative contracts and closer to the monopoly prices).

particular scenario of harm relies on a particular package of pre-requisites (e.g., market share, product differentiation, feasibility of bundling, margins). Examples can be given of the types of evidence that might be provided to support or eliminate a particular theory of harm. Other types of information are also useful (e.g., existing contracts, sales practices, procurement methods; natural experiments). The assessment of the effects of a vertical merger must not presume consumer harm and then look for countervailing efficiencies. In other words, the model used to analyze a vertical merger must allow for potential efficiencies from the start and not for competitive harm only.

9. Guidelines should distinguish "more likely" from "less likely" competitive harms wherever possible.

While it is not possible to be absolutely precise, qualitative guidance may be provided on the relative risks of different types of harm. For example, there is usually a far greater concern if foreclosure results in exit as opposed to changes in market share. 'Safe harbours' might be indicated, at least in relation to the pre-requisite of market power.[5] (See principle 4 above.) In particular, if none of the firms involved in a merger can be found to have significant market power in any of the markets (in the horizontal sense), then there is almost always no need for a competition authority to scrutinize this particular merger, as it is very unlikely it will be anticompetitive. Overall, the scale of likelihood should tie appropriately with the required standard of proof for the Commission.

[5] If, after an umpteenth vertical merger, the upstream market is supplied by vertically integrated firms only, there is a risk that upstream firms could sustain higher prices for the upstream products, forcing (not vertically integrated) downstream firms to raise their final prices. So the number of firms acting in the different markets plays here a crucial role.

10. Non-Horizontal Guidelines should be consistent with other Guidelines / Notices / Green Papers.

For example, the horizontal merger guidelines can be interpreted to define existing market power in the context of a non-horizontal merger case (even though those guidelines deal directly with changes to market power, not the existence of market power). If the recent discussion paper on Article 82 leads to new guidelines, there will be some important links to the Non-horizontal mergers Guidelines, in particular because firms may find various ways to establish vertical relationships among themselves (e.g. long-term specific contracts) that possibly replicate part of what would be achieved via a merger (though we are aware that the Article 82 prohibition provides insufficient protection to make ex ante merger regulation unimportant). There should also be consistency with notices on vertical restraints.

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