EU Commission Draft Non-Horizontal Merger Guidelines.

Introduction.

The EU Commission draft guidelines for non-horizontal mergers outline the Commission's proposed approach for assessing vertical and conglomerate mergers.[1] The Guidelines represent a further step in the reform of EU competition law by which the Commission has sought to move to a more economics based rather than a legalistic approach.

They outline the circumstances in which non-horizontal mergers might adversely affect competition and explain how the Commission will analyse such cases. They do not provide a simple checklist that would enable merging parties to assess whether or not a particular transaction is likely to be approved. Rather they outline the analytical approach that the Commission will adopt in such cases. They represent an attempt to establish a set of "basic rules" for such cases. Interested parties have until 12th May to make submissions on the Draft Guidelines.

Effects of Non-horizontal Mergers.

Traditionally merger policy has tended to focus on mergers between competing firms, referred to as horizontal mergers. Such mergers, by definition, result in a decline in the number of competitors.

Vertical mergers involve firms at different levels of the supply chain, e.g., a manufacturer and a distributor or a manufacturer and a supplier of raw materials, normally raise fewer competition concerns.

Over the past twenty years the potential for dominant firms to engage in strategic behaviour by raising rivals' costs has been highlighted in the economics literature. While strategies such as predatory pricing may be effective at preventing entry and maintaining a dominant position, they involve some cost to the dominant firm. Strategies that raise rivals' costs are a more attractive option for a dominant firm, especially if they do not raise the dominant firm's own costs.

In recent years vertical integration has become the primary focus of the raising rivals' cost literature. Theory demonstrates that vertical integration by a firm with market power in one market can, in certain circumstances, lead to anti-competitive price increases and/or market foreclosure.

For example, a firm may acquire control over distribution outlets in order to deny its rivals access to a significant proportion of the possible customers. Alternatively, it may acquire control of a source of essential raw materials through acquisition in order to deny its rivals access to them or to force them to rely on inferior quality supplies.

Main Features of Commission's Proposals.

As a starting point, the Guidelines note that non-horizontal mergers are less likely to create competition concerns than horizontal mergers. They also state that such mergers are generally considered to pose no threat to competition unless the merged entity would have market power in at least one of the relevant markets in which it operates.

They suggest that market shares and the level of concentration in relevant markets can provide a useful initial indicator of possible market power. The Guidelines propose a potential "safe harbour" for non-horizontal mergers stating that the Commission is unlikely to raise concerns where the merged entity's market share is below 30% and the post-merger HHI is less than 2000 in any relevant market.

They go on to state that the Commission will use these thresholds as an initial indicator of the absence of competition concerns. It qualifies this by stating that they involve "no legal presumption" but states that the Commission will not extensively investigate mergers below these thresholds "except where special circumstances" are present. The following special circumstances are identified:

(a) a merger involves a company that is likely to expand significantly in the near future, e.g., because of a recent innovation;

(b) there are significant cross-shareholdings or cross-directorships among the market participants;

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[1] The Draft describes the latter as involving firms where the relationship is neither purely horizontal nor vertical and states that the focus of the guidelines is on conglomerate mergers involving firms in closely related markets such as where the products are complements or belong to the same product range.

(c) one of the merging firms is a firm with a high likelihood of disrupting coordinated conduct;

(d) indications of past or ongoing coordination, or facilitating practices, are present.

Two broad categories of possible anti-competitive effect arising from vertical mergers are identified in the Guidelines and it classifies these as non-coordinated and coordinated effects. As in the case of horizontal mergers, coordinated effects refers to a situation in which the merger increases the likelihood of collusion post-merger. Non-coordinated effects arise mainly where a non-horizontal merger would result in foreclosure as a result of which the merging companies may be able to profitably increase prices to consumers.

The term "foreclosure" is defined as "any instance where actual or potential rivals' access to supplies or markets is hampered or eliminated as a result of the merger, thereby reducing these companies' ability and/or incentive to compete."

Foreclosure of Inputs or Customers.

The Guidelines identify two forms of potential foreclosure arising from a vertical merger.

(i) Where the proposed merger involves a firm merging with an upstream supplier of an essential raw material, giving it the potential to deny access to rivals (input foreclosure).

(ii) Where the proposed merger involves a firm merging with an important customer in the downstream market, thereby restricting rivals' access to a sufficiently large customer base (customer foreclosure).

In order to establish whether or not a vertical merger will result in input foreclosure, a number of questions need to be considered. 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, and third, whether a foreclosure strategy would have a significant detrimental effect on competition downstream. The draft points out that these factors are often examined together since they are closely intertwined.

The incentive to foreclose depends upon whether or not such a strategy would be profitable, which in turn depends on the relative size of upstream and downstream profits. The lower the margin on the upstream product (the input) and the higher the margin in the downstream market the greater the incentive to foreclose. It also depends on the extent to which sales lost by rivals would be diverted to the merged firm's downstream arm.

In the case of customer foreclosure, the first question to be addressed is whether there are sufficient other customers left in the downstream market. The Guidelines note that customer foreclosure will only result in higher prices to downstream rivals if there are significant economies of scale and scope. If existing upstream rivals are operating at or close to their minimum efficient scale, the denial of access to a substantial downstream customer may increase their variable costs, forcing them to raise prices to remaining downstream customers.

Where a substantial customer is foreclosed, this reduces the revenue prospects for potential entrants making entry unattractive, which may cause prices to downstream firms to remain higher than they would otherwise. As in the case of input foreclosure, it is also necessary to establish whether customer foreclosure would be profitable.

Coordinated Effects.

There are a variety of ways outlined in the Guidelines in which a vertical merger may increase the likelihood of coordinated behaviour. Foreclosure will reduce the number of firms in the market. A vertical merger may also increase the degree of symmetry between firms and may result in the elimination of a maverick. All of these factors may make coordination easier to achieve.

Vertical integration may increase market transparency, by giving the merged firm access to information about its rivals and may also make it easier for it to punish rivals if they deviate from a coordinated strategy, because it is either a crucial customer or supplier.

Conglomerate Mergers.

The main concern identified with conglomerate mergers in the Guidelines is the possibility that they may enable the merged firm to foreclose one or other market by engaging in tying or bundling. The Guidelines note, however, that such practices are not necessarily anti-competitive.

In considering whether a conglomerate merger would result in foreclosure, it is necessary to establish whether it would be possible for the merger entity to engage in tying or bundling. There is an incentive for firms to abandon tying or bundling strategies in response to entry in one or other market. As the Guidelines correctly note, this means that it must be able to commit to not reversing such a strategy in response to entry in order to foreclose either market.

Efficiencies from Mergers.

The Guidelines recognise that efficiency gains may offset any anti-competitive effects of non-horizontal mergers. For example, vertical mergers may:

(i) Eliminate double mark-ups, thus increasing sales and lowering the final price to customers;

(ii) Improve coordination of production and distribution thus reducing inventory costs;

(iii) Align the parties' incentives to invest in new products, new production processes and marketing (before the merger, the upstream firm might be reluctant to invest in training the sales force of the downstream entity as this would also benefit its upstream rivals).

Similar efficiencies may also arise in the case of conglomerate mergers.

Assessment.

The setting out of a framework for the analysis of non-horizontal mergers constitutes a welcome development but there are some problems with the Guidelines as drafted.

The Guidelines state that foreclosure might arise even where foreclosed rivals are not forced to exit the market. Rather they provide that it is sufficient that rival firms are disadvantaged and thus able to compete less effectively. This obviously raises a question as to the extent to which rival firms must be disadvantaged. Greater clarity is required on this point.

In addition, the Guidelines note that, in the case of customer foreclosure, any negative effect on consumers may take some time to materialize. When the primary effect of foreclosure is on the revenue streams of upstream rivals, it may reduce their ability to invest in cost reduction, product innovation and other dimensions, by reducing their revenue streams, but such effects will only appear over time. It will obviously be difficult to assess the impact of a merger on competition if any adverse effects will not be apparent for some time, increasing uncertainty about the Commission's likely view of certain cases.

The economics literature recognises that raising rivals' costs strategies need not always be anti-competitive and that there are circumstances where they may have a beneficial impact on welfare. Some argue that it is not absolutely clear where the dividing line between raising rivals' costs strategies and legitimate competitive behaviour lies. Such uncertainty increases the risk of incorrect decisions.