Competition Competence Report

INPUT AND CUSTOMER FORECLOSURE: NON-HORIZONTALE MERGER GUIDELINES

The European Commission is currently working on guidelines for vertical and conglomerate mergers (non-horizontal guidelines). The thoughts on these guidelines within the European Commission are already very well developed. Even the size of the guidelines is clear: 20 pages. With these guidelines the European Commission aims to provide insights how the economic assessment of vertical and conglomerate mergers should be performed. Target groups of the European Commission's guidelines are the national competition authorities, business people and their advisers. A large part of the new guidelines will deal with vertical mergers. While our last CCR dealt with tying and bundling, this CCR focuses on potential competitive harm by vertical mergers. In particular, input and customer foreclosure are discussed.

Input and Customer Foreclosure

In contrast to horizontal mergers which may, by eliminating competition between the merging parties, or by increasing the scope of collusion, give rise to a significant impediment of effective competition, vertical mergers are less likely to produce negative economic effects. In fact, vertical mergers might even have some positive impacts on consumer welfare. In particular, it is generally accepted in economic theory that vertical mergers might eliminate the double marginalisation problem and opportunistic behaviour. Other positive results might be lower transaction costs, increasing efficiencies in input choices and other static and dynamic efficiencies. Under exceptional circumstances, vertical mergers may give rise to two types of foreclosure concerns. One necessary (but not sufficient) condition for foreclosure to occur is that the merging parties have on one market stage considerable market power.

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If the merging firm has market power on the upstream level input foreclosure might arise. Input foreclosure may create the incentive for the combined entity to foreclose its competitors on the downstream market. This might occur if the merged firm can rise rival's cost by increasing their input prices whereas the downstream entity of the firm still has access to the input at marginal costs, thus, gaining a competitive advantage. Input foreclosure also arises, if the merged firm stops supplying rivals of its downstream entity, denying completely the access to the input.

Conversely, downstream- or customer foreclosure occurs where the downstream firm exclusively purchases inputs from the upstream divisions of the combined firms post-merger.

However, customer foreclosure is generally seen as less harmful than input foreclosure. Due to vertical integration, unintegrated upstream firms may have a smaller addressable market, which could make it difficult for them to cover their fixed costs. But the unintegrated firms' pricing is not likely to change and the integrated firms' prices might even be lower due to efficiencies. Only if the unintegrated rivals exit the market, the merged firm might be able to raise prices above competitive levels. But these effects result in the long term only and, thus, are subject to some speculation. Moreover, rivals have enough time to discover alternative ways to reach the customers.

On the other hand, input foreclosure leads to immediate price effects. The unintegrated firms face higher prices and, thus, have to raise their prices. If the supply of input is denied, unintegrated firms must find alternative sources that probably are more expensive. If they can not find a substitute for the input they might even exit the market, what increases the market power of the remaining firms and probably leads to price increases. Therefore, input foreclosure is likely to be more harmful than customer foreclosure.

The European Commission's Non-Horizontal Merger Guidelines

It can be assumed that the European Commission will publish guidelines which focus on undisputable findings. It is not likely that the European Commission will rely on specific models and their respective results since they often hinge on very restrictive assumptions and can not be applied to real world cases. Therefore, the intended guidelines will elaborate on general insights that have been gained on input and customer foreclosure over the years and can be fond in every textbook on competition econom-

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ics. In the following, this CCR proposes certain conclusions that can be drawn from these general insights and are – what is of great importance in economic practise - applicable to real cases. It is very likely that the guidelines of the European Commission reach quite similar conclusions.

Input Foreclosure

- Ability of the upstream firm to raise the input price to downstream rivals

The degree of market power in the upstream market is essential: if the upstream market is still sufficiently competitive and if downstream firms are able to substitute easily to alternative inputs, the likelihood that the upstream firm is able to raise the input prices to downstream competitors is small. Thus, it should be evaluated, if there are a sufficient number of upstream firms that have an incentive to continue to sell their products to independent downstream firms. If downstream firms already buy from various upstream suppliers switching costs might be comparatively low. If there is only a low degree of market power on the upstream market, it is not likely that the upstream firm is able to raise the input prices and thus input foreclosure is not likely to occur.

- Likelihood that an increase in the input price leads to an increase in the price charged to end-consumers

Absent the increase in the output price of downstream firms, the incentive to increase the price of the input in order to implement a raising rival's cost strategy vanishes. Thus, to harm competition an increase in the input price charged by the integrated or merged firm to downstream customers must result in an increase in the price charged by downstream firms to their customers as the higher profit downstream constitutes the benefit of a vertically integrated firm that engages in a strategy of input foreclosure. Thus, if the likelihood that an increase in the input price results in a price increase of the end-consumer is low, input foreclosure is not likely to occur either.

- Increase in downstream profits must exceed the costs of the input foreclosure

While implementing input foreclosure, costs in form of a loss in upstream profits arise: these costs which can be traced back to the decision of the integrated firm to forego sales for its product to downstream rivals have

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to be considered as well. Input foreclosure thus is only rational if the higher downstream profits are greater than the lower upstream profits. Thus, input foreclosure will not arise if the costs in form of lower upstream profits are high.

- Commitment

Companies should be given the possibility to commit not to engage in input foreclosure. If the market is transparent, the supervision of such commitments - enabling firms to realize merger-specific efficiencies and to reduce at the same time possible anti-competitive effects - is easy.

- Counterstrategies

Feasibility of counterstrategies: the possibility that downstream rivals counter-merge with an upstream rival could ensure competition. Thus for input foreclosure to be become likely, counterstrategies must be impossible on the relevant market. If counterstrategies are feasible, input foreclosure is not likely to arise.

- Potential Benefits

Possible efficiency enhancing effects must be taken into account as well: e.g. the elimination of double marginalisation constitutes a possible efficiency of a vertical merger. More efficiencies could result because of reduced costs and increased productivity. It has to be taken into account, that the conditions that lead to efficiencies create the possibility for foreclosure at the same time. The positive competitive effects in terms of efficiencies can countervail the negative effects. Thus, a careful balancing is required while analysing the effects of vertical mergers.

Customer Foreclosure

- Exercise of market power

The ability to exercise market power is essential in this respect. Due to the fact that anticompetitive customer foreclosure is only credible if both the upstream and downstream market is conducive to the exercise of market power, in particular the ability of the merged firm to control the access to the end-users is assessed. Thus, a careful analysis of the distribution channels and the ways products are sold into the downstream market is required. If there is no evidence for market power on the downstream level, customer foreclosure is not very likely to arise.

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➢ Switching Costs

The assessment should consider the switching costs faced by customers. Whether customers are locked in depend on a variety of factors, such as terms and duration of supply contracts and possibility of renegotiation. In the case of low switching costs the likelihood of customer foreclosure is low either.

➢ Benefits of vertical mergers

The merger analysis must consider potential efficiency gains. As was already pointed out, the potential harm of customer foreclosure is inferior to that of input foreclosure. Therefore, it is far less likely that the potential competitive harm outweighs the benefits a vertical merger might generate. The positive competitive effects in terms of efficiencies can countervail the negative effects. Thus, a careful balancing is required while analysing the effects of vertical mergers.

Safe Harbour

Because of these different aspects, pro- and anticompetitive ones, the European Commission created a "safe harbour". In the style of the market share thresholds concerning vertical restraints, the market share threshold regarding vertical mergers should be higher than the threshold with relation to horizontal mergers. In addition, the use of HHIs should be avoided to be in line with the vertical regime: The block-exemption covers vertical agreements concerning final and intermediary goods as well as services of companies whose market share is below 30% in the relevant market. Thus, even a vertical merger with a market share below 30% should benefit from the so-called "safe harbour" under the Community competition rules.

EE&MC Approach

EE&MC recommends the use of a merger simulation model to analyse the competitive effects of vertical mergers. This approach applies an econometric model that simulates market outcomes. Various market parameters and economic data are collected and fed into a simulation model. Merger simulation models are suitable to meet the specific requirements of a vertical merger analysis. A merger simulation model incorporates the specification of the supply and the demand side and other effects that are of importance regarding vertical mergers: in particular efficiencies and

counterstrategies of rivals are taken into account as well. Thus, merger simulation models provide quantitative assessment of vertical mergers permitting the balancing of efficiencies and anticompetitive effects.

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