International and Comparative Competition Law

Mergers – Part 1

Recall: US and EU Substantive Merger Control Tests

	US	EU
Substantive Test	*"No person … shall acquire … the whole or any part of the stock or other share capital and no person … shall acquire the whole or any part of the assets of another person … where … the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly."* **Clayton Act § 7**	*"A concentration which would significantly impede effective competition, in the common market or in a substantial part of it, in particular as a result of the creation or strengthening of a dominant position, shall be declared incompatible with the common market."* **EUMR, Article 2**
Primary Substantive Guidance	• Clayton Act § 7 • FTC/DOJ Horizontal Merger Guidelines (2010) • FTC Statement on Negotiating Merger Remedies	• EU Merger Regulation (2004) • Implementing Regulation (2004) • Horizontal Merger Guidelines (2004) • Non-Horizontal Merger Guidelines (2008) • Relevant Market Notice (1997) • Remedies Notice (2008)

“Mergers” Can Take Many Forms

Horizontal	Potential (Horizontal) Competition	Vertical	Conglomerate

Antitrust Issues?

More Common — Rare

Overview of Analytical Framework

Market Definition	Relevant Product Markets
	Relevant Geographic Markets
Market Power	Market Shares
	HHIs/Concentration Level
Unilateral Effects	Closeness of Competition
	Ability to Raise Prices Profitably/UPP
Coordinated Effects	Transparency
	Removal of Maverick
Vertical/ Conglomerate Mergers	Risk of Foreclosure – e.g. bundling/tying
	Coordinated Effects
Defenses	Entry/Potential Competition + Efficiencies
	Failing Firm + Buyer Power
Remedies	Structural
	Behavioral

Primary Theories of Harm

HORIZONTAL CONCERNS	— Unilateral effects — Coordinated effects
VERTICAL CONCERNS	— Input foreclosure — Customer foreclosure

Regulators' assessment will include review of documentary evidence, detailed economic assessment and feedback from market participants

Recall: Relevant Product Market – Basic Principles

- Relevant market: market in which a monopolist could profitably raise prices above competitive levels
- Comprises all products that are sufficiently substitutable to constrain each other
- Demand-side substitution
    - Would customers switch to substitute in the event of a price rise?
    - Would sufficient consumers at the margin switch to defeat price increase?
    - Relevant perspective: Marginal consumer not average consumer
- Supply-side substitution
    - Would suppliers switch production in the event of a price rise?
    - Switch must be feasible within a short period and with little cost

"The relevant product market comprises all those products that customers regard as interchangeable or substitutable to the product(s) of the undertaking(s) involved, based on the products' characteristics, their prices and their intended use, taking into consideration the conditions of competition and the structure of supply and demand on the market ."

- European Commission Market Definition Notice, Para. 12(a)

Recall: Relevant Geographic Market – Basic Principles

- Geographic area where suppliers are subject to the same competitive constraints
- Demand-side substitution
  - Would customers source from different area in the event of a price rise?
- Supply-side substitution.
  - Would suppliers from different areas start supplying in the event of price rise?

> *"The relevant geographic market comprises the geographic area in which the undertakings involved supply or demand relevant products, in which the conditions of competition are sufficiently homogeneous for the effects of the conduct or concentration under investigation to be able to be assessed, and which can be distinguished from other geographic areas, in particular because conditions of competition are appreciably different in those areas."*
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> \- European Commission Market Definition Notice, Para. 12(b)

Market Power, Market Shares and Concentration Level

- Market shares and concentration levels provide useful first indicator of market structure and market power/competitive importance of the merging parties
- Commission Horizontal Guidelines
  - Presumption of no competitive concerns where combined shares are below 25%
  - Effective presumption of dominance where combined shares are above 50%
- Key Questions
  - Volume vs. value vs. capacity shares?
  - Historic, current, vs. future shares?
  - Bidding markets?
  - Volatility?
  - Barriers to entry?

Market Power, Market Shares and Concentration Level - HHIs

- The Herfindahl-Hirschman Index (HHI): A measure of market concentration
  - Sum of the squares of the individual firms' market shares
    - 2 firms with 30% share, 2 firms with 20% share → HHI = $30^2 + 30^2 + 20^2 + 20^2 = 2{,}600$
    - Two largest firms merge → New HHI = $60^2 + 20^2 + 20^2 = 4{,}400$
    - Change in HHI from merger is 1,800
- US Horizontal Merger Guidelines
  - Presumption of illegality if: Post-merger HHI >1,800 and change in HHI >100 OR post-merger share >30% and change in HHI >100
  - *"When exceeded, these concentration metrics indicate that a merger's effect may be to eliminate substantial competition between the merging parties and may be to increase coordination among the remaining competitors after the merger."*
- EU Horizontal merger Guidelines
  - Presumption of no SIEC for mergers resulting in HHI below 1,000 or HHI change below 150, or HHI below 2,000 with HHI change below 250
  - Exceptions: potential entrants, innovators, mavericks, past coordination, one party with shares over 50%
- Agency practice tends to be more generous: few mergers that result in a post-merger HHI of below 3,000 are challenged

Unilateral Effects

Will the combined firm be able to raise prices profitably?

- Will the merged firm, upon raising prices, "recapture" sales it would have lost to the other firm ("diverted sales")

Do the parties' products compete particularly closely for a substantial portion of customers?

- Primarily applies to differentiated products: do the parties' products have features, quality, etc. more similar to each other than to the products of other competitors?
- Pre-merger, firm may be reluctant to raise prices due to diversion to competitors' substitute products – the consumers' second choice
- Can also apply to bidding: how often is one party the "runner up" when the other party wins?

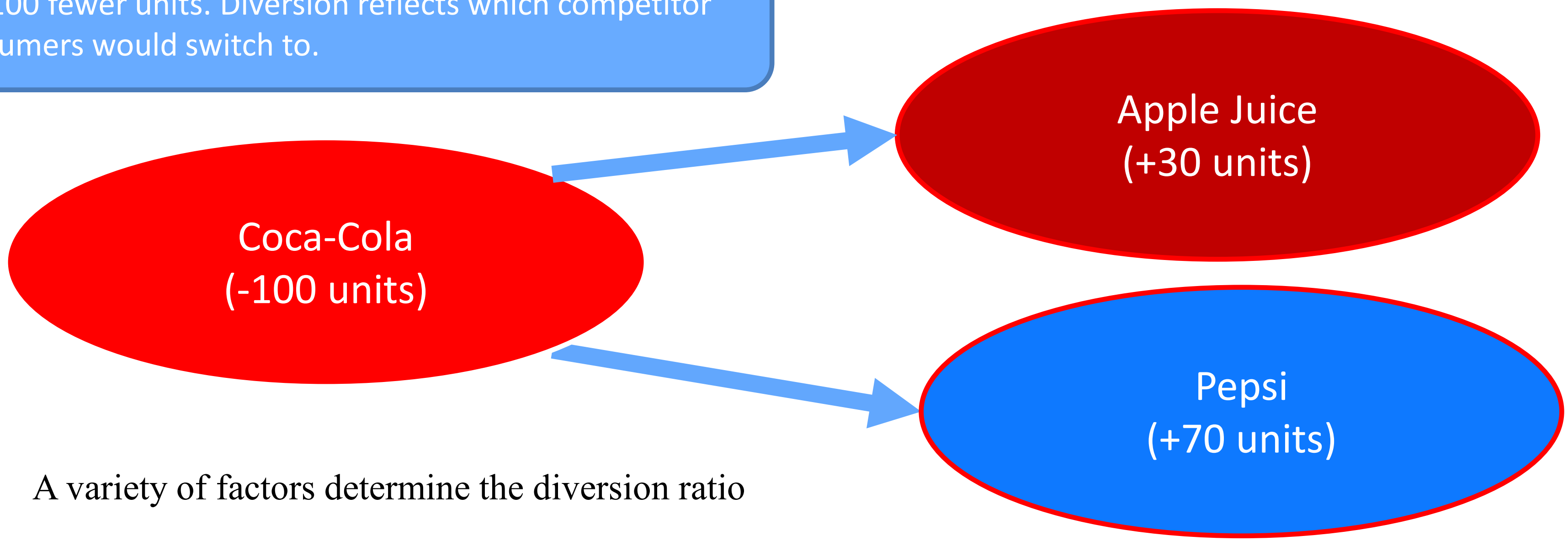
The greater the value (gross margins achieved) of the diverted sales, the greater the potential anticompetitive concerns.

- UPP

Diversion Ratios

- Diversion ratios consider how a firm's demand curve changes due to a transaction (how will the transaction change how consumers respond to a price change)
- Diversion asks: if one of the parties were to raise prices or reduce quality, to whom would it lose customers?

Pre-merger, if Coca-Cola raised its prices by 5%, it would sell 100 fewer units. Diversion reflects which competitor consumers would switch to.



- A variety of factors determine the diversion ratio

Diversion Ratios – How do you get them?

- Diversion data is not easy to find – by definition it requires isolating the effect of a price or quality change
    - Even data showing switching between products after a price change cannot guarantee that the reason for the switching was due to the price change (i.e., correlation does not equal causation)
    - Natural Example: Survey data where consumers identify the reason for switching products was a price change
    - Can also use econometric analysis to estimate the likelihood of switching (and to which competitor) in response to a price or quality change, based on consumer's characteristics and previous choices
- Other data can be imperfect proxy
    - Switching data, current share data, current new customer capture rate, etc.
    - Must be careful about "noise" in data. For instance, switching for reasons other than price or quality changes between substitutable products: for example, plenty of 35 year old men switch from motorcycles to minivans for reasons other than price or quality changes

Using Diversion Ratios:
GUPPIs and the Quantification of the Effect of a Merger

- GUPPIs ask whether, given the level of diversion between one merging party and the other and the profit margins, the merger would create incentives to raise prices
- GUPPI =

$$\frac{\text{Value of diverted sales that are re-captured (recaptured units * profit margin)}}{\text{Value of the lost sales because of price increase (units lost * price)}}$$

- Firms can divert sales from a low margin product to a high margin product – sales that are diverted aren't really lost
  - Higher Diversion Ratio → More re-captured sales
  - Higher Profit Margin and Relative Price → Divert sales to a more profitable product
- A GUPPI below 5% is often used to screen out mergers with no competitive concern
- Critically, a GUPPI analysis without accounting for efficiencies can be misleading
  - A merger between two firms in the same market will always lead to some upward pricing pressure
  - A full merger simulation can be used to incorporate efficiencies and show their counteracting effect

Coordinated Effects: Overview

Will the merger lead to increased coordination between remaining firms?

- Merger might enable "accommodating conduct" -- Remaining firms can undertake conduct that is profitable only because other firms accommodate the behavior
- Coordinated effects more likely where firms can predict how other firms will react to competitive changes (e.g., price increases)
- Includes conduct that would not otherwise be unlawful under the antitrust laws

Coordinated effects are more likely where:

- There are few firms (oligopolistic industry)
- Prices and output decisions are transparent (e.g., prices are public), especially for homogenous products
- Firms have an ability to detect and "punish" deviations from coordinated behavior
- There is evidence of previous express collusion in the relevant market
- Buyers are small or have little buyer power (otherwise firms will have an incentive to compete for large contracts)
- A merger eliminates a "maverick" player that would, but-for the merger, disrupt any attempted coordination

Case Study – Airbus/Bombardier C-Series

Unilateral Effects Unlikely – Lack of Close Competition

- C Series and Airbus rarely compete directly, and don't compete at all above 150 seats
- Below 150 seats, Airbus is marginal and competition remains: primarily with Embraer and secondarily with Boeing

Market Not Vulnerable to Coordination

- Large and infrequent bids, airline preference for uniformity across fleets provide strong incentives to "flip" a customer
- Unpredictable sealed bids → "cheating" difficult to detect or punish
- Complex bids involve many competitive variables beyond price
- Large airlines have significant buyer power

Transaction Does Not Increase Risk of Coordination

- Airbus will continue to compete vigorously against Boeing across broader portfolio
- Adding C Series makes Airbus and Boeing less similar
- Due to high cost base, in the long run C Series could never be a low-price maverick without Airbus
- With duties, C Series cannot compete in U.S. today

Vertical Mergers

"*Vertical mergers involve companies operating at* <u>*different levels of the supply chain*</u>*. For example, when a manufacturer of a certain product (the "upstream firm") merges with one of the distributors (the "downstream firm") this is called a vertical merger.*"

- EU Non-Horizontal Merger Guidelines, para.4

"Non horizontal mergers are generally less likely to significantly impede effective competition than horizontal mergers […] *However,* <u>*there are circumstances*</u> *in which non horizontal mergers may* <u>*significantly impede effective competition*</u>*, in particular as a result of a strengthening of a dominant position*"

- EU Non-Horizontal Merger Guidelines, paras.11 and 15

"The Commission is unlikely to find concern in non-horizontal mergers, be it of a coordinated or of a non-coordinated nature, where the market share post-merger of the new entity in each of the markets concerned is below 30 % (3) and the post-merger HHI is below 2 000."

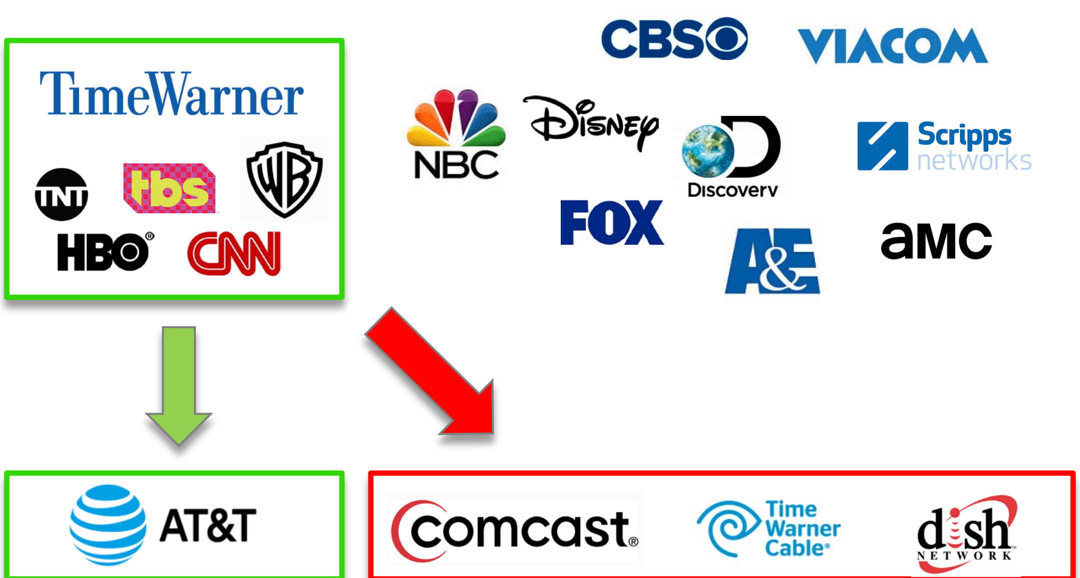
- EU Non-Horizontal Merger Guidelines, para. 25

Vertical Mergers

- Key question: Ability and incentive to foreclose – and whether foreclosure would have anticompetitive effects on customers/competition
- But also remember potential for Coordinated Effects!
- "Safe harbor"
  - Non-horizontal mergers will not pose a threat to effective competition unless the merged entity has a significant degree of market power (not necessarily dominance) in at least one of the markets concerned.
  - Safe harbor where market share is below 30% or post-merger HHI below 2,000.
  - Commission will not extensively investigate except if:
    - the merger involves a company that is likely to expand significantly in the near future
    - Significant cross-shareholdings or cross-directorships among market participants
    - One of the merging firms has a high likelihood of disrupting coordinated conduct
    - Indications of past or ongoing coordination or facilitating practices are present

Vertical Mergers – Input Foreclosure and RRC

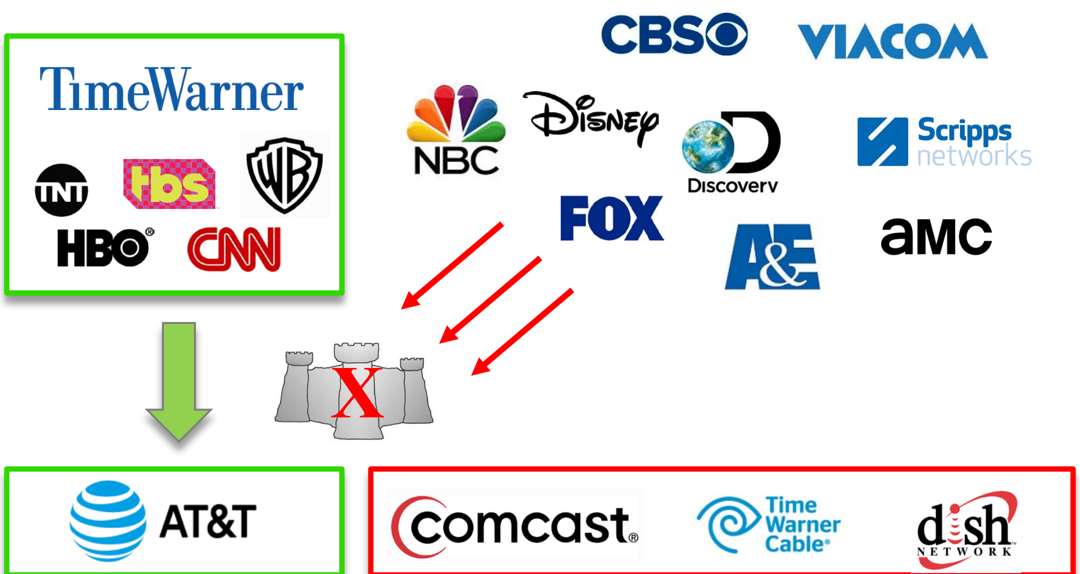
- Assume vertically-integrated firm tries to raise price of input sold to downstream rivals
  - Will newly-integrated firm be able to extract higher price? How critical is the input for downstream rival?
  - Will more downstream customers switch from competitors to vertically-integrated firm?
  - What are the value of new sales downstream and (presumably) fewer sales upstream, but at a higher price?
- Incentives depend on factors such as margins, market share, importance of upstream input



"AT&T/DirecTV would hinder its rivals by forcing them to pay hundreds of millions of dollars more per year for Time Warner's networks . . . ."

Vertical Mergers – Customer Foreclosure

- Similar to input foreclosure, customer foreclosure is the exclusionary effect of a customer with significant buying power demanding higher prices from upstream competitors
- This can result in, for instance:
  - Increasing the upstream competitors costs by reducing its scale (assuming scale efficiencies)
  - Increasing market power of upstream division (by weakening competitors)



DOJ complaint in AT&T/Time Warner did not allege harm from customer foreclosure.

Conglomerate Mergers

"Conglomerate mergers are mergers between firms that are in relationship which is neither horizontal (as competitors in the same relevant market) nor vertical (as suppliers or customers) (…) They are mergers between companies that are active in closely related markets (e.g. markets involving suppliers of complementary products or products that belong to the same product range."

- EU Non-Horizontal Merger Guidelines, para. 5

- Unlikely to raise concerns – except where one of the parties has market power and seeks to leverage that into another market
  - Input/customer foreclosure – potentially as a result of bundling or tying
- Similar analysis to vertical mergers

Mergers Involving Platforms

- "Guideline 9" in New US Horizontal Merger Guidelines
- *"When a merger involves a multi-sided platform, the agencies examine competition between platforms, on a platform, or to displace a platform"*
- Transaction types
  - Mergers of platform operators
  - Platform operator acquiring platform participant
  - Acquisition of multiple firms providing services to multiple platforms
  - Acquisition of firms providing other input to platforms

- Need to consider:
  - Multiple sides to platform
  - What services does the platform operator provide?
  - Who are the platform participants? Buyers or suppliers or both? Is the platform operator also a participant?
  - Network effects
  - Risk of self-preferencing?
  - Horizontal/Vertical/Conglomerate concerns

Defenses

- Ease of Entry
  - Entry or repositioning of competitors would constrain any anticompetitive effects caused by the merger
- Efficiencies
  - Efficiencies will outweigh any competitive harm caused by the merger
- Buyer Power
  - Customers will counterbalance the increase in market power caused by the merger
- Failing Firm
  - The target would collapse imminently absent the transaction

Entry

New competitors will enter the market

- Will retain competition and constrain merged entity

Analysis focused on three factors:

- Will entry be timely? (Usually within two years)
- Would entry be likely? (Would it be sufficiently profitable? Or possible given barriers?)
- Would entry be sufficient? (Would it reduce prices enough?)
- If "yes" on all three, entry can counteract potential harm from merger

"Potential Competition"

- Can also be used offensively by the agencies, if one party was prepared to expand capacity, or if the parties do not currently overlap but one party is a "potential competitor"

Efficiencies

Guidelines recognize that mergers can create efficiencies and lower costs by allowing merging firms to better utilize assets, offsetting anticompetitive effects

To offset potential anticompetitive effects, efficiencies must be:

Merger-specific (*i.e.*, they would not be achieved but-for the merger)	Verifiable and cognizable	Not achieved through anticompetitive reductions in output or service	Of such a magnitude to outweigh the potential harm

Failing Firm

Merger is unlikely to be anticompetitive if the "imminent failure" of one of the merging firms would otherwise cause its assets to exit the market

Four conditions for the failing firm defense to be met:

- Absent the acquisition, the firm's assets would exit the market
- Firm unable to meet its financial obligations in the near future
- Firm could not reorganize under Chapter 11 of the bankruptcy laws
- Firm has made unsuccessful, good-faith efforts to find other buyers

Where these conditions are met, "the projected market share and significance of the exiting firm is zero"

Remedies

- Remedies can be proposed during or at end of review
- Remedies must be
  - Capable of eliminating the competition concerns identified entirely
  - “Workable and lasting" and "comprehensive and effective from all points of view”
  - Capable of being implemented effectively and expeditiously
- Strong preference for structural remedies
  - Stand-alone business vs. carve-out – need viable business
  - Crown jewels
  - Non-reacquisition clause
  - Post close buyer vs. up-front buyer vs. fix-it-first
  - Suitable purchaser – independent of the parties, who doesn’t create competition concerns

Remedies

- In exceptional circumstances – regulators consider alternate remedies – e.g.
    - Access to Infrastructure or Technology
    - Termination of Exclusive Agreements
    - Supply of Products or Services to Third Parties
    - Purchase of Products from Third Parties
    - Separate Management of Assets
    - Undertaking to Remove Risk of Coordination