VIEWPOINT:

The Final Piece In The Jigsaw: An Analysis Of The Draft European Commission Guidelines On Non-Horizontal Mergers

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The Final Piece In The Jigsaw: An Analysis Of The Draft European Commission Guidelines On Non-Horizontal Mergers

by

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On February 13, 2007, the European Commission (the “Commission”) published its long-awaited draft guidelines outlining the analytical framework that it intends to apply to non-horizontal mergers (the “Draft Guidelines”). The Draft Guidelines complete a series of important recent developments in European Union merger control practice, including most notably the amendment of the substantive test for merger review and publication of the Horizontal Merger Guidelines in 2004.¹

Non-horizontal mergers involve companies active in vertical (e.g., manufacturer and distributor) or related (e.g., complementary or neighboring) markets – the latter sometimes being referred to as “conglomerate” mergers. They differ from horizontal mergers in key respects.

First, and most obviously, unlike horizontal mergers – which lead to a loss of direct competition between the merging firms – non-horizontal mergers do not immediately lead to a reduction in the number of competing firms in any given market.

Second, in the case of non-coordinated effects theories, the creation or strengthening of market power in non-horizontal merger cases typically results from strategic conduct that the merged entity would undertake post-merger (e.g., refusals to deal, tying and bundling) – in contrast to market power caused by structural changes to the market in the case of horizontal mergers.

Third, non-horizontal mergers involve two or more different product markets whereas horizontal mergers typically involve only one. The analysis of competitive effects is therefore multi-layered in the case of non-horizontal mergers and often more complicated.

Finally, non-horizontal mergers can create efficiencies that are completely absent in the case of horizontal mergers. They can for example reduce transaction costs by replacing contractual relationships between previously independent actors with more efficient intra-group arrangements.


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Fundamental differences between horizontal and non-horizontal mergers compel the general conclusion that most non-horizontal mergers raise no competitive issues. Despite widespread agreement on this basic premise, Commission practice in the area of non-horizontal mergers has not been without controversy. The Draft Guidelines come in the wake of a series of Community Court judgments in Tetra Laval/Sidel and GE/Honeywell in which the Commission’s approach to non-horizontal mergers – and in particular conglomerate mergers – was criticized, mainly on grounds of insufficiency of evidence substantiating the Commission’s theories of competitive harm.2 These cases also attracted criticism from various quarters, including the United States – where the antitrust agencies have undertaken extremely limited enforcement against non-horizontal mergers. As such, they were regarded by some as a major point of divergence between EU and U.S. antitrust laws.3

This Article examines in detail the extent to which the Draft Guidelines now set out a coherent and economically sound approach to non-horizontal mergers. In particular, this Article examines how the Commission has distilled the key principles from recent Community Court judgments and responded to the various criticisms made of past Commission practice in this area. Our conclusion is that the Draft Guidelines largely incorporate the key principles arising from these recent judgments and generally appear to provide a workable framework for the future assessment of non-horizontal mergers, broadly in line with current economic thinking. Indeed the Draft Guidelines largely consolidate recent practice in this regard: the Commission had already been applying the principles now enshrined in the Draft Guidelines in its recent decisional practice.

That said, important questions of substance and emphasis appear to have been either overlooked or given insufficient attention in the Draft Guidelines. Issues developed further in this Article include: (1) the need for greater recognition of the fact that theories of non-horizontal merger harm are generally difficult to justify and so will only apply in exceptional circumstances; (2) that the market share levels suggested in the Draft Guidelines at which competition harm can generally be excluded are in some respects set too low; (3) the need for more specific guidance on the meaning of competitor foreclosure and the benchmarks that should apply in this regard; (4) that more prominence should be given to the notion that customers will often receive a net benefit (i.e., lower prices) from many forms of non-horizontal merger (and which may offset any competitor foreclosure); (5) the need for more detailed, practical guidance on the conditions for the assessment of efficiency gains in non-horizontal mergers; and (6) the need for an integrated approach in the Commission’s parallel Article 82 EC review.

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The following structure is adopted. Section A briefly summarizes the enforcement background that led to the adoption of the Draft Guidelines. Section B then sets out the Draft Guidelines’ general comments on non-horizontal mergers. Sections C and D then deal in more detail with the approach taken in the Draft Guidelines to vertical and conglomerate mergers, respectively. Section E critically analyzes the approach taken in the Draft Guidelines and highlights areas for further improvement or clarification. Finally, Section F contains a short conclusion.

A. Background To The Draft Guidelines

Non-horizontal mergers have, in many ways, had a disproportionate impact on Commission decisional practice under the EU Merger Regulation. Of the 19 prohibition decisions adopted since the entry into force of the EU Merger Regulation in 1989, 58% were based on purely horizontal grounds; 11% included both horizontal and non-horizontal elements; and 31% identified purely non-horizontal concerns. Similarly, since entry into force of the new EU Merger Regulation in 2004, there have been nine cases where, after a Phase II investigation, the Commission required remedies as a condition for clearance. Of these nine cases, five (56%) were based on purely horizontal grounds; three (33%) included both horizontal and non-horizontal elements; and one (11%) was purely non-horizontal.4

Commission enforcement policy against non-horizontal mergers has, however, had something of a checkered past. This was particularly true with regard to conglomerate mergers where the Commission has subjected a number of clearance decisions to detailed conditions, e.g., Tetra Pak/Alfa-Laval,5 Coca-Cola Enterprises/Amalgamated Beverages GB,6 Guinness/Grand Metropolitan,7 and Procter & Gamble/Gillette.8 Some of these decisions – particularly earlier ones – gave rise to a degree of confusion over the Commission’s reliance on “portfolio effects” theories. It was not clear for example whether merely having a wide complementary product range could raise potential issues in its own right. Equally, there appeared to be insufficient recognition of the pro-competitive aspects of bundling and other practices in connection with multiple products, leading to allegations of over-protection of rivals.

The most significant source of controversy, however, concerned two high-profile prohibition decisions adopted by the Commission in General Electric/Honeywell and

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5 Case IV/M.68.
6 Case IV/M.794.
7 Case IV/M.938.
8 Case COMP/M.3732.
9 Case COMP/M.2220.
**Tetra Laval/Sidel**\(^\text{10}\) – based to a large extent on vertical and/or conglomerate effects. Both cases were appealed to the Community Courts. **Tetra Laval/Sidel** was overturned on appeal while the Court of First Instance in **General Electric/Honeywell** struck down the Commission’s vertical and conglomerate findings, but upheld the decision overall due to horizontal overlaps. Taken together, these cases attracted criticism from certain quarters and were said to be out of kilter with mainstream economic thinking and enforcement policy in the United States and elsewhere.\(^\text{11}\) In more detail, the main criticisms were as follows:

First, it was argued that non-horizontal mergers rarely raise competition problems and typically benefit consumers. A relatively strict enforcement policy against non-horizontal mergers was therefore said to be unsound in economic theory. The most influential theory in this regard is the so-called “single monopoly profit” associated with the Chicago school of antitrust thinking.\(^\text{12}\) This holds that in a vertical chain of production, there is a single monopoly profit to be had (rather than there being successive monopoly profits at each stage of production). A firm that has a monopoly at one level of the vertical chain can secure that profit if it charges a monopoly price for its product and everyone else charges a competitive price for their products. The monopolist therefore has no incentive to monopolize additional levels of the distribution chain because it can never extract more profit than it currently obtains from having a monopoly at one level (and, indeed, would all things equal prefer that these other links in the chain remain competitive). Although the single monopoly profit theory only applies under certain assumptions – an issue to which we return later – it has held great intellectual sway in the approach to non-horizontal mergers in the United States and elsewhere.\(^\text{13}\)

\(^{10}\) Case COMP/M.2416.

\(^{11}\) See, e.g., W Kolasky, *Mario Monti’s Legacy: A U.S. Perspective*, 1 COMPETITION POLICY INT., 155, 164 (2005); D Patterson & C Shapiro, *Trans-Atlantic Divergence in GE/Honeywell: Causes and Lessons*, ANTITRUST MAGAZINE, November 12, 2001; D Platt-Majoras, Deputy Assistant Attorney General, Antitrust Division, *GE-Honeywell: The U.S. Decision*, remarks to the Antitrust Law Section State Bar of Georgia, November 29, 2001, available at [http://www.usdoj.gov/atr/public/speeches/9893.htm](http://www.usdoj.gov/atr/public/speeches/9893.htm) (“After fifteen years of painful experience with now long-abandoned theories like entrenchment, the U.S. antitrust agencies concluded that antitrust should rarely, if ever, interfere with any conglomerate merger. We simply could not identify any conditions under which a conglomerate merger, unlike a horizontal or vertical merger, would likely give the merged firm the ability and incentive to raise price and restrict output. We recognized, conversely, that conglomerate mergers have the potential as a class to generate significant efficiencies.”). For press articles, see H. Varian, *Economic Scene; In Europe, GE and Honeywell ran afoul of 19th-century thinking*, N.Y. TIMES, June 28, 2001 (“When evaluating a merger, United States antitrust officials tend to focus on the benefits to consumers, while European regulators give substantial weight to the impact on competitors, especially if they are ‘national champions.’”) and G. Priest, *The GE/Honeywell Precedent and Franco Romani*, WALL ST. J., June 20, 2001.


\(^{13}\) It is worth noting, however, that the situation was not always thus in the United States. The 1968 U.S. Merger Guidelines were relative hostile to vertical integration, regarding as problematic a vertical merger between firms accounting for only 10% and 6% of sales in their respective markets. See generally F.
Second, it is argued that Commission policy – particularly in regard to conglomerate mergers – risks protecting competitors rather than competition. Foreclosure theories in the case of non-horizontal mergers generally assume that the merged entity would engage in certain post-merger strategic conduct (e.g., tying or bundled pricing) that, while benefiting consumers in the short-term, may lead to a long-term reduction in competition that would later allow the merged entity to raise prices through the exercise of market power.

Critics argue that such an approach risks downplaying the present certainty that, in the short to medium term at least, consumers benefit from efficiencies (e.g., lower bundled pricing or beneficial technical integration of two or more products), whilst giving prominence to speculative theories that long-term competitor harm could later lead to consumer harm. This criticism is essentially a variant of recoupment analysis in exclusionary pricing cases – the idea being that consumers are net beneficiaries unless initial low prices or other advantages are offset by subsequent reductions in output or price increases.

Finally, it was argued that the strategic conduct underpinning non-horizontal merger theories of harm was better suited to ex post review under anti-monopolization laws such as Article 82 EC. Trying to prevent the anticipated possibility of such conduct under ex ante merger control laws risked deterring efficient practices or practices whose long-term effects are ambiguous. This applies in particular to practices such as tying and bundling where the potential competitive effects are complex and not easy to predict ex ante.

The above criticisms were partly accurate, but also partly misplaced. Detailed review of past Commission decisional practice falls outside the scope of this Article, but it was generally the case that actual Commission practice tended, on the whole, to be quite cautious. Non-horizontal merger theories were generally pursued where the merged

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15 S Baker & D Ridyard Portfolio Power: A Rum Deal? 20(4) EUR. COMPETITION L. REV. 181, 183 (1999) (“This difficulty raises the question of whether tying is an abuse which is amenable to ex ante intervention through merger policy or whether it should be controlled ex post using other tools of competition law. The introduction of “portfolio power” theories into merger control certainly blurs the distinction between the control of market structure and the control of firms’ behavior.”).

16 For a considered response to the main criticisms leveled at the Commission, see G Drauz, Unbundling GE/Honeywell: The Assessment of Conglomerate Mergers under EC Competition Law, 2001 Fordham Corporate Law Institute 183 (BE Hawk, ed., 2002).

17 For a detailed treatment, see N Levy, European Merger Control Law (2006), Lexis Nexis, Chs. 12 (conglomerate mergers) and 13 (vertical mergers).
entity had existing market power in at least one product market and held non-replicable advantages over rivals in other markets.

Indeed, most of the criticisms leveled by the Community Courts in Tetra Laval/Sidel and GE/Honeywell concerned the demanding evidential requirements for theories of non-horizontal merger harm as applied to the factual peculiarities of each case. The theories relied upon by the Commission were not fundamentally called into question. For example, in GE/Honeywell the Court of First Instance did not specifically reject the theory that GE’s 10% share in aircraft purchasing and leasing could lead it to exert a disproportionate influence in vertically related markets such as aircraft engines. Instead, the gravamen of the Commission’s vertical foreclosure theory was the absence of any credible evidence that the same pattern could be extended to other aircraft components such as Honeywell’s avionics equipment.

Similarly, in the area of vertical mergers, the Commission tended to exercise vigilance mainly in markets where incumbent firms controlled essential inputs used by downstream rivals (e.g., telecoms, media, and energy) and where exclusionary actions would probably be difficult to detect and remedy ex post. As a result, EU policy on vertical mergers was generally regarded as more orthodox, with most of the criticisms being directed at conglomerate mergers.

It is also important to appreciate that Commission practice had, in any event, advanced substantially prior to the Draft Guidelines. In particular, the Commission had already begun to implement a multi-stage test for assessing foreclosure in non-horizontal merger cases, together with demanding evidential requirements. A good example of the Commission’s application of that test is found in GE/Amersham. There, the Commission applied the following analysis of foreclosure:

- First, it established its theory of possible competitive harm – namely that the merged entity would engage in various types of anticompetitive bundling.

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18 See, e.g., Case C-12/03, Commission v Tetra Laval BV [2005] ECR I-987, ¶ 44 (“The analysis of a conglomerate-type concentration is a prospective analysis in which, first, the consideration of a lengthy period of time in the future and, secondly, the leveraging necessary to give rise to a significant impediment to effective competition mean that the chains of cause and effect are dimly discernible, uncertain and difficult to establish. That being so, the quality of the evidence produced by the Commission in order to establish that it is necessary to adopt a decision concerning the concentration incompatible with the common market is particularly important, since that evidence must support the Commission’s conclusion that, if such a decision were not adopted, the economic development envisaged by it would be plausible.”).

19 See, e.g., Case COMP/M.3696 E.ON/MOL, Case COMP/M.3440 EDP/ENI/GDP (on appeal in Case T-87/05, EDP v Commission, judgment of September 21, 2005) (energy); Case IV/M.553 RTL/Veronica/Endemol, Case COMP/M.2876 News Corp/Telepiu (media); and Case COMP/M.2803 Telia/Sonera (telecoms).

20 Case COMP/M.3304. See also Case COMP/M.3083 GE/Instrumentarium.
Second, having identified a relevant theory of possible harm, the Commission assessed whether, in the case at hand, the merged entity would be able to engage in the anticompetitive behavior, in particular through its ability to “leverage its pre-merger dominance in one product to another complementary product.”

Third, the Commission assessed whether, even if such a strategy was possible, there was a “reasonable expectation that rivals will not be able to propose a competitive response.”

Fourth, if rivals were not able to respond, the Commission assessed whether “their resulting marginalization will force them to exit the market.”

Finally, even if rivals would exit the market, the Commission assessed whether the merged firm could “implement unilateral price increases and such increases need to be sustainable in the long term, without being challenged by the likelihood of new rivals entering the market or previously marginalized ones re-entering the market.”

B. General Framework

The Draft Guidelines’ general discussion of non-horizontal mergers in any event goes a long way towards addressing the main criticisms of past Commission practice, as well as certain popular misconceptions that appear to have arisen in this regard. Key statements on basic principles include the following:

First, non-horizontal mergers “are generally less likely to create competition concerns than horizontal mergers” (¶ 11).

Second, non-horizontal mergers “provide substantial scope for efficiencies,” (para 13). For example, vertical mergers can replace the monopoly profits of two firms at two different stages of product with a lower internalized mark-up of a single, integrated firm. There may also be transaction cost savings and better planning of production and distribution.

Third, it can be presumed that non-horizontal mergers pose no threat unless the merged entity has market power. As a rebuttable presumption, the Draft Guidelines state that the Commission is unlikely to take action where the post-merger share in each of the markets concerned is below 30% and the post-merger Hirschman-Herfindahl Index is below 2000 (¶ 25).

Fourth, the ultimate concern in non-horizontal mergers is harm to consumers, whether intermediate or final consumers (¶ 16). The fact that a merger affects competitors is not in and of itself a problem.
Fifth, responding to some of the popular misconceptions about the Commission’s “portfolio effects” cases, the Draft Guidelines confirm that the mere fact of having a broad range of products does not in itself raise concerns (¶ 103).

Finally, strategic conduct carried out in response to a non-horizontal merger (e.g., tying and bundling) may be efficient in many cases (¶ 92).

C. The Approach To Vertical Mergers

In its discussion of the competition problems that can arise from vertical mergers, the Commission distinguishes between cases involving: (1) issues of unilateral (or non-coordinated) effects resulting from foreclosure of rivals by the merged entity; and (2) issues of coordinated effects between the merged entity and rivals. Only vertical foreclosure is treated in detail in this Article, since the Commission has relied on coordinated effects theories in only a handful of vertical merger cases. Moreover, the applicable principles for coordinated effects are the same as for horizontal mergers and, moreover, are reasonably clear.21

The Draft Guidelines distinguish between two forms of vertical foreclosure: (1) input foreclosure; and (2) customer foreclosure.22 Input foreclosure arises where the merger is likely to raise the costs of downstream rivals by restricting their access to an important input that is owned or controlled by the merged entity. These cases are similar to the vertical foreclosure issues that arise in so-called “essential facility” cases under monopolization laws. In contrast, customer foreclosure relates to the opposite situation – where the merger is likely to foreclose upstream rivals by restricting their access to a sufficient customer base (¶ 29). Both forms of foreclosure essentially rely on the same underlying theory – that limiting rivals’ access to inputs or customers can increase their costs and, if the foreclosure is extensive enough, may lead to price increases.

For both forms of foreclosure, the Draft Guidelines set out a three-part test, whether: (1) the merged entity would have the ability to substantially foreclose access to

21 See Case T-342/99, Airtours plc v Commission [2002] ECR II-2585. See too Case T-464/04, Independent Music Publishers and Labels Association v Commission, judgment of July 13, 2006 (currently on appeal). As is the case under the Horizontal Merger Guidelines, the Commission’s treatment of coordinated effects is essentially based on the Airtours case law, with three conditions necessary for coordination to be sustainable: (1) the existence of sufficient transparency to reach terms of coordination and monitor deviations, (2) the existence of deterrent mechanisms, and (3) the inability of outsiders to disturb the tacitly agreed upon outcome (¶¶ 81-89). One interesting observation is the Commission’s decision not to deal with the CFI’s comments on these conditions in its recent Impala judgement. For example, the Draft Guidelines do not argue, as the CFI did in Impala, that the presence of indicia of coordinated effects may be sufficient to conclude that a pre-existing collective dominant position is present. This is perhaps not surprising given that an appeal is pending in the Impala matter before the ECJ.

inputs/downstream markets; (2) it would have the incentive to do so; and (3) a foreclosure strategy would have a significant detrimental effect on competition downstream (¶¶ 31, 58):

- **Ability to foreclose access.** For input foreclosure to be a concern, the vertically integrated firm resulting from the merger must have market power in the upstream market, whereby it could negatively affect the overall availability of inputs for the downstream market in terms of price or quality (¶ 34). The foreclosure must concern an important input, e.g., where the input represents a significant cost factor, the input constitutes a critical component without which the downstream product cannot be manufactured or sold, the input represents a significant source of product differentiation, or the cost of switching to alternative inputs is relatively high (¶ 33).

In customer foreclosure cases, the vertical merger must involve an undertaking that is an important customer in the downstream market. This depends on whether there are sufficient economic alternatives in the downstream market for the upstream rivals to sell their products. If there is a sufficiently large customer base that is likely to turn to independent suppliers, competition concerns are unlikely to arise (¶ 60). An important clarification in this connection is that upstream rivals’ ability to compete can only be impaired if there are significant economies of scale or scope in the input market (¶ 61). If there are such economies, denying upstream producers access to important downstream customers can increase their costs of production and so lead to price increases.

- **Incentive to foreclose access to inputs.** The incentive to foreclose depends on the degree to which foreclosure would be profitable. This is an empirical question that involves comparing the merged entity’s trade-off between the possible costs associated with reducing input sales to rivals (in the case of input foreclosure) and not procuring products from upstream rivals (in the case of customer foreclosure) and the possible gains from doing so (¶ 39, 67). In many cases, even a dominant upstream supplier will have no incentive to foreclose downstream rivals, e.g., if they are more efficient downstream producers, if they sell differentiated products, or if the downstream market is larger and more profitable than the upstream market. The Commission will examine both the incentives to foreclose as well as the factors liable to reduce, or even eliminate, those incentives, including the possibility that the conduct is unlawful. Thus while the Draft Guidelines do not formally deal with the “single monopoly profit” critique of vertical merger enforcement policy, their treatment of the issue of incentives probably leads to a similar conclusion.

One issue that may also affect the merged entity’s incentives to engage in foreclosure conduct is whether that conduct would violate Article 82 EC.
In this regard, the Draft Guidelines state that the Commission will consider, on the basis of a summary analysis: (1) the likelihood that this conduct would be clearly, or highly probably, unlawful under Community law, (2) the likelihood that this illegal conduct could be detected, and (3) the penalties which could be imposed (¶¶ 44, 70).

- **Overall likely impact on effective competition.** The final step entails the application of the “significant impediment to effective competition” test. This requires at a minimum that enough rivals would be adversely affected by the merged entity’s post-merger conduct to allow the merged entity to raise prices. Thus, the affected firms must “play a sufficiently important role in the competitive process on the downstream market” (¶ 46) or, put differently, “a sufficiently large fraction of…output” must be affected (¶ 73). Foreclosure could also occur in the case of vertical mergers through increased barriers to entry (¶ 47). For example, if downstream rivals are worried about refusals to deal or discriminatory treatment by a vertically-integrated input supplier, this might require them to enter at both the upstream and downstream levels, which will typically increase entry costs and risks.

The Draft Guidelines also sum up countervailing factors that might offset the anticompetitive effects from the merger. However, consideration should also be given to whether arrangements falling short of a full merger (e.g., arm’s-length contracts) would achieve a similar result. Efficiencies include reduced transaction costs, elimination of double monopoly mark-ups, and better coordination of production and planning (¶¶ 53, 54).

**D. The Approach To Conglomerate Mergers**

Conglomerate mergers involve firms that are in neither a horizontal nor a vertical relationship, but instead compete on closely related or neighboring markets. Typically, the merging firms will sell different products falling within the same product range, i.e., different products, but purchased by the same customers for the same broad end-use.

The Draft Guidelines clarify that conglomerate mergers do not raise issues in the “majority of cases” and that specific conditions are required to establish competition harm (¶ 91). As with vertical mergers, the Draft Guidelines’ treatment of conglomerate mergers makes a basic distinction between cases involving unilateral foreclosure and cases of coordination with rivals. Again, we only focus on foreclosure cases here.

The basic concern in conglomerate merger foreclosure cases is that the merged entity could have the ability and incentive to leverage its position into a related/neighborly market by engaging in practices such as tying or bundling. While such practices are often pro-competitive, the Draft Guidelines state that they may in certain circumstances reduce rivals’ ability to compete, reducing competitive pressure on
the merged entity and, if the foreclosure is serious enough, allowing it to raise prices (¶ 93).

The proposed analytical framework for conglomerate mergers is similar to that for vertical merger foreclosure. This makes sense because vertical and conglomerate mergers raising foreclosure issues are generally indistinguishable from the ultimate consumers’ point of view. Both ultimately involve strategic conduct that, if sufficiently exclusionary, is tantamount to a refusal to deal. A recent OECD publication on conglomerate mergers gives the following example:

“Suppose firm A held the patent and was the only firm selling brake lights that customers installed in the back windows of their cars. Suppose further that before any of its competitors did so, car manufacturer believed it could install such lights while a car was being assembled at lower costs than consumers could after they purchased a new car. If it initially decided to purchase brake lights, but later merged with that firm, the merger would be treated as a vertical merger. If instead it had never purchased the lights, the merger would be a conglomerate merger. Despite the classification difference, the pro- and anti-competitive effects of the two mergers would be the same.”

Accordingly, as with vertical mergers, the Draft Guidelines set out a three-stage test based on the merged entity’s ability and incentives to engage in post-merger exclusionary conduct and what the effects on consumers of such conduct are likely to be:

- **Ability to foreclose.** The Draft Guidelines state that a pre-condition for being able to engage in foreclosure behavior is market power in at least one relevant market. Absent such power, strategic behavior designed to exclude rivals is unlikely to be attempted, or to be successful if attempted. A second important factor cited in the Draft Guidelines is that there is a large pool of common customers for the individual products concerned. If there are no common customers for the products, it is much less likely that tying, bundling, and other exclusionary practices can affect demand for stand-alone rivals’ products. Another method of foreclosure is where potential entrants are contemplating entry as stand-alone producers of one product and the merged entity’s ability to tie/bundle two or more products would deter such entry (¶ 100). This applies in particular for technical tying, which may be more costly to reverse. Finally, the Draft Guidelines state that the merged entity’s ability to tie/bundle may be countered by the ability of stand-alone producers to make joint offerings.

- **Incentive to foreclose.** As with vertical mergers, the issue of incentives to forecast is said by the Draft Guidelines to turn on the degree to which the tying, bundling or other exclusionary strategy is profitable (¶ 104). Tying,

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bundling, or other strategies may involve some loss of business (e.g., if enough customers still wish to purchase stand-alone products), but there may also be gains in market share or price increases. In considering the incentives to engage in strategic conduct, the Draft Guidelines state that the relative sizes and profitability of the tied and tying markets (if the latter is more profitable/larger than the former, a tying strategy may not make sense) and the possibility that the conduct itself could be unlawful (if the conduct is clearly unlawful and easily detectable, the incentives to carry it out are much less) are important factors (¶¶ 106-108).

- **Adverse effect on competition.** The Draft Guidelines state that merely reducing rivals’ sales does not in itself harm competition (¶ 109). Instead, there must be a sufficiently large reduction in competition to allow the merged entity to raise prices, *i.e.*, a “sufficiently large fraction of market output” must be affected (¶ 111). Countervailing factors such as buyer power, market entry at an upstream or downstream level, and efficiencies also need to be considered.

Regarding efficiencies, the Draft Guidelines correctly point out that conglomerate mergers raise a strong presumption of efficiencies, since there will usually be economies of scope and reduced transaction costs in supplying two or more products (particularly where purchased by the same customers for the same end use).

**E. Assessment**

The Draft Guidelines generally provide a useful framework for analyzing non-horizontal mergers, as well as being broadly in line with current economic thinking. The Commission is generally to be applauded for embarking on the intellectually ambitious effort of drafting non-horizontal merger guidelines.24 Although a similar document was published by the U.S. antitrust agencies as early as 1982,25 these guidelines are somewhat theoretical in approach. Moreover, unlike their horizontal merger counterparts, the U.S.


25 See Non-Horizontal Merger Guidelines, available at http://www.usdoj.gov/atr/public/guidelines/2614.htm. These guidelines originally appeared in the non-horizontal section (Section 4) of the 1982 Merger Guidelines. The 1982 Merger Guidelines were subsequently reprinted and the section and renamed the Horizontal Merger Guidelines, with the section on non-horizontal mergers disappearing. Thus the Non-Horizontal section of the 1982 Merger Guidelines remains the official position of the DOJ and the FTC on non-horizontal mergers,
Non-horizontal Merger Guidelines were not revised to take account of subsequent developments in the economics literature.

There are also good reasons to suppose that the final guidelines will be closely followed by the Commission in practice. Indeed, as noted above, it was already the case prior to the Draft Guidelines that the Commission had begun to apply the principles to be distilled from the Community Courts’ judgments in Tetra Laval/Sidel and GE/Honeywell. Notable recent examples of the multi-stage approach to foreclosure and anti-competitive effects in non-horizontal merger cases include the treatment of conglomerate effects in GE/Amersham and vertical effects in recent energy mergers such as E.ON/MOL and EDP/ENI/GDP. Thus, the Draft Guidelines to a large extent consolidate existing practice.

However, important issues of substance and emphasis have in our view been either overlooked or given insufficient attention in the Draft Guidelines. We focus below on a number of these issues:

- First, the Draft Guidelines should give greater recognition to the fact that theories of competitive harm in non-horizontal merger cases are generally difficult to justify and so will only apply in exceptional circumstances. Reading the Draft Guidelines, one is left with the impression that non-horizontal mergers invariably require complex, multi-stage analysis. In fact, the inference should be the opposite: non-horizontal mergers rarely raise competitive issues and only do so under demanding conditions.

- Second, the Draft Guidelines are in many cases unduly cautious about the concentration levels at which competition harm can generally be presumed not to exist.

- Third, the Draft Guidelines need to give greater specificity to the meaning of competitor foreclosure and the benchmarks that should apply in this regard. The issue should not be so much how many competitors are foreclosed but what type of competitors are foreclosed (e.g., if they are close competitors to the merged entity and reasonably efficient) and whether that foreclosure is permanent;

- Fourth, although the Draft Guidelines state that competitor foreclosure does not equate to competitive harm, a more basic point not treated in detail is that many forms of non-horizontal merger foreclosure will be offset by consumer gains;

26 Case COMP/M.3304.
27 Case COMP/M.3696.
28 Case COMP/M.3440.
Fifth, more detail is needed on how efficiencies in non-horizontal mergers will be assessed in practice, e.g., to what extent contractual alternatives need to be realistic, etc; and

Finally, any final set of non-horizontal merger guidelines will need to ensure an integrated approach with the Commission’s parallel Article 82 EC review. This not only affects the debate about whether ex ante enforcement under Article 82 EC is an effective deterrent, but also goes to efficiencies, and in particular whether it would be legal for a firm with market power to write certain contracts that are less restrictive than a non-horizontal merger.

1. **The Exceptional Circumstances For Competitive Harm**

The Draft Guidelines correctly comment that non-horizontal mergers “are generally less likely to create competition concerns” (¶ 11). They then proceed with a lengthy discussion of the forms of market structure and types of behavior that could give rise to problems, as set out in Sections C and D above, without, however, clarifying the underlying economic framework within which all non-horizontal mergers can be explored.

An explicit discussion of this framework in the Draft Guidelines would have been useful in order to provide support both for the contention that non-horizontal mergers are less likely to give rise to competition concerns, and to explicitly identify factors in which competition concerns could arise. Such an approach should consider the two underlying economic mechanisms that can give rise to competition problems from non-horizontal mergers:

a. **The “efficiency offense”**

Competition problems may arise from non-strategic behavior if the merged firm becomes unassailably more efficient than its rivals as a result of merger. As identified above, the initial effect of a non-horizontal merger is often an efficiency effect – internalizing a pricing externality that allows a merged firm to reduce the downstream price of its products, i.e., the double marginalization or “Cournot” effect. This, in turn, puts greater pressure on downstream rivals to reduce their prices, which ordinarily leads to reduced prices to final consumers.

But if the efficiency effect is strong, this could result in rivals exiting the market and competitive constraints on the merged firm weakening to the extent necessary to allow it ultimately to raise prices. For this to happen, it must also be the case that many rivals are marginally profitable so a significant proportion would exit in response to lower prices from the merged firm, that rival downstream firms cannot carry out a

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counter-merger (or alternative contractual relationship) with another upstream rival in order also to access the same efficiencies, and that rivals face barriers to re-entry.

The detriment to competition here is the so-called “efficiency offense” – which, at least in part, appeared to form the basis of the Commission’s case for prohibiting GE/Honeywell. Critics of the decision argued that the mixed bundling theories posited by the Commission in respect to GE engines and Honeywell avionics and non-avionics systems, denied consumers the benefit of lower prices in order to protect non-integrated rivals:

“Even accepting for the sake of argument the conclusion that GE had a dominant position in engines, we disagreed with the EU's conclusion that the merger would strengthen that position. That finding necessarily rests entirely on ‘range effects’ - in this case, the theory that GE and Honeywell would engage in "mixed bundling" by offering a package of GE engines and Honeywell avionics and non-avionics systems at discounted prices. The EU predicted that ‘bundling would lead to a re-allocation and therefore to a shift of market share in favor of the merged entity’ to such an extent that over the longer term GE's competitors would be unable to cover their fixed costs and would exit the market.”

Subsequent Commission statements have denied that an “efficiency offense” theory applies under the EU Merger Regulation:

“In relation to this, I would at once like to refute the assertion that the European Commission, when dealing with conglomerate mergers, is in fact applying what has been dubbed an ‘efficiency offence.’ Indeed, we distinguish clearly between – on the one hand – mergers leading to price reductions that are the result of strategic behavior on the part of a dominant firm, the purpose of which is to eliminate or marginalize competitors with a view to exploiting consumers in the medium term, and – on the other – mergers which will objectively lead to significant and durable efficiency gains that are likely to be passed on to the consumer...”

Similarly, the Commission’s Draft Guidelines do not appear to consider that this possibility should be explored as a source of competitive harm. If so, it would be useful if it could be spelled out more clearly.

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b. **Strategic post-merger foreclosure**

The second mechanism by which non-horizontal mergers could give rise to competition problems, and the area which the Draft Guidelines appear to concentrate upon, is strategic behavior. The merging firm could have a further incentive to exclude rivals by leveraging its leading (“strong”) market position into its second (“weak”) market, foreclosing rivals from the weak market and weakening competitive pressures. This appears to be the main source of unilateral effects competitive harm explored within the Draft Guidelines. (The distinction between input foreclosure, customer foreclosure, and tying and bundling is essentially one between the identity of the merged firm’s weak and strong markets rather than the underlying economics.)

This behavior is “strategic” in that the merged firm only has an incentive to carry out these actions if rival downstream firms also change their behavior. In this regard, it is useful to distinguish two types of strategic behavior. First, there is “weak foreclosure” in the sense that the merged firm’s upstream arm engages in behavior that is only profitable if downstream rivals change their prices. In contrast, “strong foreclosure” takes place if the upstream arm of the merged firm engages in behavior that is only profitable if it results in downstream rivals exiting the market or reducing their expansion plans.

The Draft Guidelines appear to concentrate only on strong foreclosure, as further discussed in Section C and D above. If so, it would be important to elaborate on the conditions that are required to sustain such theories. In essence, such theories are a variant on the “profit sacrifice” theory advocated for certain forms of strategic conduct under monopolization laws. When engaging in strong foreclosure the merged firm is sacrificing profits that it could make in its strong market to try to change the competitive situation in the weak market. The merged firm only has an incentive to carry out this behavior if it weakens competition at the downstream level sufficiently for the increased downstream profits to offset the sacrificed upstream profits. Extrapolating from this basic theory, at least the following five criteria need to be satisfied for this to occur:

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32 The profit sacrifice test was originally proposed by industrial economists in the early 1980s. See J Ordover and R Willig, *An Economic Definition of Predation: Pricing and Product Innovation* 91 Yale L J 18 (1981). The economists defined exclusionary behavior as a “response to a rival that sacrifices part of the profit that could be earned under competitive circumstances were a rival to remain viable, in order to induce exit and gain consequent additional monopoly profits.” *Id.*, at 9–10. A variant is the “no economic sense” theory. See G Werden, “The ’No Economic Sense’ Test for Exclusionary Conduct,” paper submitted to the British Institute of International and Comparative Law, 5th Annual Antitrust dialogue, London, May 9–10, 2005.

33 These conditions essentially flow from the so-called “post-Chicago” economics literature. Beginning in the 1980s, certain economists began to question the broad assumptions underlying Chicago School thinking. In particular, they found that it was possible to develop models in which leveraging behavior could be shown to harm consumer welfare. The seminal article is probably M.D. Whinston, Tying, Foreclosure, and Exclusion 80 AMERICAN ECONOMIC REVIEW 837 (1990). See also J.P. Choi and C. Stefanadis, Tying, Investment, and the Dynamic Leverage Theory, 32 RAND JOURNAL OF ECONOMICS 52 (2001); D.W. Carlton and M. Waldman, The Strategic Use of Tying to Preserve and Create Market Power in Evolving Industries 33 RAND JOURNAL OF ECONOMICS 194 (2002). For a non-technical summary, see
First, the merging firm must have a strong position in its strong market. Most theoretical models derive their results on the basis that the merged firm has a monopoly in one market. Whilst a monopoly position is not strictly necessary, it is the case that the likelihood of anticompetitive outcome is substantially higher the stronger the position of the firm in its strong market.

Second, the weak market must be imperfectly competitive and the merged firm also needs to have a reasonably strong position in that weak market. If the second market is perfectly competitive, then the Chicago School critique holds that there is only one monopoly profit to be gained. Thus, any attempt to increase profits in the second market by sacrificing profits in the first market is a zero sum game. In reality, few markets are perfectly competitive, so the Chicago School critique is unlikely to hold completely – although the closer to perfectly competitive the second market is, the less there is to gain.\(^{34}\) Thus, as a general matter, the merged firm will need to have a fairly strong existing position in the weak market in order to be able to benefit from any reduced competition post-merger. The weaker its current position is, the less likely it is that any foreclosing behavior will be profitable.

Third, rivals must be substantially dependent on the sales or purchases of the merged firm’s stronger arm. In the case of input foreclosure, the merged firm must be able to deny downstream rivals access to a key input either completely or substantially, so that they are not able to replace with alternative or equally good sources of supply. Equally, downstream firms must not be able to readily replace their current operating technology so as to be able to deliver the same final product without requiring the foreclosed input.

Fourth, rival firms must not be able to counter-merge with a rival supplier to the merged firm’s dominant arm (or replicate the efficiency or incentive benefits through contractual means). Detrimental effects from non-horizontal mergers rely on the asymmetry between the incentives of merged firms and standalone rivals, while counter-merger restores symmetry.

Finally, even if there is foreclosure and the prospect of higher prices in the future, consumers may still benefit if prices decrease overall or in the short

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\(^{34}\) The Chicago critique also depends on other strict assumptions, including that downstream customers use the two products in fixed proportions (if not, they can switch to another input mix) and that all available market power in the strong market has already been exercised (if not, the monopolist may be able to strengthen its position).
term. Overcoming the double marginalization may reduce average prices to customers even if there is some weak foreclosure. The main detrimental effects of strong foreclosure may occur far in the future (for example, where re-entry decisions are made irregularly as they relate to large capacity investments) whereas consumers may benefit immediately from lower post-merger prices.

It can be seen that the conditions required for a non-horizontal merger are stringent. Given that the direct effect of a merger is typically that prices to final customers will fall, it would be helpful if the Guidelines were to spell out more directly the underlying framework and further contextualize the fact that non-horizontal mergers will typically not give rise to competition problems save in exceptional circumstances. At the moment, the Draft Guidelines simply make a statement to this effect without much additional explanation. Further, although the discussion in the Draft Guidelines of the various types of problem is helpful, presentationally (albeit understandably) the reader is left with the impression that vertical merger problems are rife given the space devoted to them. It would be important in our view to preface these remarks with a more general, affirmative section indicating that non-horizontal mergers rarely raise material competition issues and to outline the exceptional circumstances in which they might do so and the strict evidential requirements that apply in this regard.

2. The Presumption Of No Competitive Harm and Market Share Thresholds

The Draft Guidelines state that “[t]he Commission is unlikely to find concern in non-horizontal mergers... where the market share of the new entity in each of the markets concerned is below [30%] and where the post-merger HHI is below [2000]” (¶ 25 (emphasis added)). In other words, the “safe harbor” occurs where the market share of the merged entity is below 30% in both markets. If the market share of the merged entity is above 30% in even one market, then the firm is outside the safe harbor (as long as it has some presence in the second market).

As a safe harbor threshold this appears in many cases to be over-cautious. It is prudent to build in low thresholds so that no merger that could potentially be detrimental to consumers is let through without proper scrutiny. But the thresholds set out in the Draft Guidelines could subject many mergers to extensive scrutiny where the likelihood of any anti-competitive non-horizontal merger effects is remote. For example, suppose there was a vertical merger with the upstream firm having a market share of 31% and the downstream firm 1%. This merger falls outside the safe harbor, since as set out above the market share in one of the markets is above 30% and there is some vertical presence.

But there are strong reasons to suppose that the prospect of anti-competitive merger effects is likely to be small. First, if foreclosure of downstream rivals were to occur, it is necessary to consider the ability of the merged firm’s downstream arm to expand output to pick up the extra sales (and so the profitability of any foreclosure behavior). But if the downstream firm currently has only 1% of the market, it is useful to
ask whether it would be holding enough spare capacity to be able to satisfy substantial extra sales shifted from downstream rivals – almost certainly not. Having a small current downstream market share suggests that the downstream firm has some constraint on its ability to satisfy customers – and so that the ability profitably to foreclose rivals is likely to be limited. This suggests that for there to be a concern, the merged firm should at least have a material presence in the second market and not merely a de minimis one.

Second, the 30% upstream market share threshold is probably too low in this instance. For there to be the possibility of foreclosure, downstream rivals – who in this case account for 99% of the downstream market – would have to be reliant on the upstream firm’s product and not to be able to switch to other upstream rivals (or find it a considerably worse substitute). This is somewhat difficult to square with the observation that the upstream market share of the merged firm is only 31%. It is reasonable to ask why, if 99% of the downstream market is substantially dependent on the upstream firm’s product, the upstream firm only has 31% of the upstream market? In practice, one would expect a market share at least approaching the level of a dominant position at the upstream level. This suggests that the threshold of concern might in some cases be too low. However, for the purposes of a screening mechanism, the 30% figure is perhaps reasonable overall and the Draft Guidelines do make clear that the input in question should normally be an unavoidable purchase for rivals.

A more nuanced approach, however, might be to employ asymmetric market share thresholds across markets. For example, it appears unlikely that competition concerns will arise if the merged firm does not have a share in the weak market of (say) at least 10%. There may additionally be a case for raising the share threshold in the strong market to, say, 40%. But since the safe harbor should be prudent and there is a benefit to maintaining consistency with the Article 81 EC Vertical Restraints Guidelines, 30% seems a reasonable level. Of course, this is not to say that mergers above these thresholds give rise to the likelihood of harm – simply that this approach distinguishes the highly unlikely from the merely possible.

3. **Assessing Competitor Foreclosure**

The Draft Guidelines correctly point out that consumer harm can only begin to occur in non-horizontal merger foreclosure cases where there is meaningful rival foreclosure. Various formulations are used, including the need for “a sufficiently large fraction of...output” to be affected (¶ 73). The Draft Guidelines also make clear that competitor foreclosure does not equal harm to competition (¶ 16). These general statements are useful and provide a basic response to the criticism that Commission policy on non-horizontal mergers protected competitors. But they also lack precision on how such foreclosure should be measured and the degree of foreclosure that is required before an inference of price rises can be made.

At some point it is of course true that an absence of competitors will lead to a reduction in competition and facilitate price rises. But the Draft Guidelines require elaboration on a number of points in this connection. First, it would be useful to make
clear that the relevant type of foreclosure is that rivals would ultimately exit the market (with no prospect for re-entry) or remain in the market as purely marginalized players (with no possibility for ramping up their activities). This is related to the point on “strong foreclosure” outlined above and the Commission’s apparent view that a mere softening of competition (or “weak foreclosure”) is insufficient to found non-horizontal merger theories of harm.

Second, the rivals in question must presumably be close competitors that place a degree of competitive constraint on the merged entity, either upstream (in the case of customer foreclosure), downstream (in the case of input foreclosure), or in neighboring markets (in the case of conglomerate mergers). An important factor will be the extent of product differentiation. The focus of foreclosure concerns should obviously be on competitors that produce close substitute products.

Third, even if rivals are in some sense close competitors to the merged entity, the Draft Guidelines needs to specify the type of competitor foreclosure that matters. The focus should generally be on as-efficient competitors (or competitors are not yet as efficient but there is a good evidential basis for saying that they would likely become so in the near-term). This is the test specified for foreclosure under Article 82 EC in the Commission’s Discussion Paper and is based on an assessment of whether a firm with the same basic costs as the merged entity would be excluded by the strategic conduct that the merged entity would likely engage in. It would make sense to adopt a similar test for non-horizontal merger foreclosure, since the basic theory of harm is generally the same.

Having regard to whether rivals are reasonably efficient of course presents complexities in certain instances and may have limited application in others. For example, where rivals’ products are differentiated, their costs relative to the merged entity clearly matter less. Equally, complex issues may arise in cases where rivals are as efficient in some markets, but have a less broad product range than the merged entity. But some objective benchmark is clearly better than none or the Draft Guidelines’ current preference for a more open-ended inquiry into the number of competitors that risk exclusion or the “fraction” of output that would likely be affected.

Another issue that would have been helpful to spell out in more detail in the Draft Guidelines is how to assess the chances that rivals will be excluded. It is crucial in this assessment to understand the cost structures of potentially excluded firms. A firm will exit immediately if it can no longer cover at least its variable costs. It will also remain in the market as long as it is covering its variable costs, even if is not covering its total costs – until the time comes that it needs to re-incur fixed and sunk costs (such as investing in a new factory to replace a factory at the end of its useful life). It is therefore necessary to know the likely size of the profit impact on rivals, the balance between fixed and variable

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35 See DG Competition discussion paper on the application of Article 82 of the Treaty to exclusionary abuses, Brussels, December 2005, para 66 (“The question is asked whether the dominant company itself would be able to survive the exclusionary conduct in the event that it would be the target.”).
costs, and the rate at which fixed costs are re-incurred. These ratios may also vary from competitor to competitor depending on their investment cycles.

Other things equal, the impact of foreclosure is greater where the profit impact is more substantial, as there is a greater chance of not covering variable costs and so exit happens immediately. The fixed/variable cost balance has complex effects. Industries with high fixed costs will typically make a high margin, and so would require a high profit impact for immediate foreclosure to occur. But having high fixed costs can make it more likely that firms will not wish to re-invest in those fixed costs if the result of the merger is that such investments would not be profitable. Finally, if fixed costs are reinvested regularly then the impact of any foreclosure will be felt more quickly. Similar arguments also apply to the case where firms are marginalized and do not expand, although the main focus here is where foreclosure will occur if firms cannot cover future fixed-cost investments needed for expansion.

Finally, at the other extreme, there may be (probably rare) cases where a non-horizontal merger affecting only a small proportion of current output could have substantial long-term anticompetitive effects. The most obvious example concerns network industries protected by very high entry barriers and substantial fixed costs. New entry in such industries can contribute significantly to dismantling barriers to entry and lead to greater innovation and convergence between markets. The Draft Guidelines allude to this possibility by saying that foreclosure concerns may be more pronounced where “the demand pattern at any given point in time has dynamic implications on the conditions of supply in the market in the future” (¶ 100). But the more important implication is that “fraction of output” affected is not always decisive when considering foreclosure. The identity and type of the foreclosed competitor may be more important in certain cases.36

4. Consumer Gains From Competitor Foreclosure

Probably the most important shortcoming of the Draft Guidelines is the relatively limited space devoted to explaining the pro-competitive effects of non-horizontal mergers and the relative weight to be attached to such effects when compared to foreclosure concerns. Apart from mentioning the principal types of efficiencies that arise in the case of non-horizontal mergers, the Draft Guidelines mainly cross-refer to the general

36 See, e.g., Competition Commission, Merger References: Competition Commission Guidelines (June 2003), ¶ 3.14 (“Particular features can be important in some markets; for example, certain markets are characterized by network effects. Such effects arise when the value of a product to a customer increases with the number of other customers consuming the same good. As a result, incumbents with an existing customer base have an automatic advantage over entrants. Markets characterized by network effects may be prone to ‘tipping’. That is, as one firm, or technology, gains an advantage in the market, in effect, the balance of power in the market ‘tips’ in its direction leaving it as the prevalent firm, or technology.”). Document available at http://www.competition-commission.org.uk/rep_pub/rules_and_guide/pdf/15073compcommguidance2final.pdf
conditions for efficiencies as outlined in the Horizontal Merger Guidelines and then add some brief comments on when efficiencies will not be present.37

This truncated approach to the pro-competitive effects significantly understates the fact that consumers will probably more often than not be net beneficiaries from non-horizontal mergers, even if there is some degree of rival foreclosure.38 In particular, the Commission’s apparent rejection of the “efficiency offence” suggests that it has sympathy with this view. Moreover, even if there is foreclosure and the prospect of higher prices in the future, consumers may still benefit if prices decrease overall, or in the short term.

For example, overcoming the double marginalization may reduce average prices to customers even if there is some (weak) foreclosure. When a supplier has market power, its wholesale price to the retailer will be at the monopoly level. If the retailer also has a degree of market power, it will take the wholesale price as a given and add its own monopoly mark-up to that cost. This leads to a double monopoly mark-up, which leads to higher consumer prices than if distribution was a competitive activity and so reduces output.39 Vertical mergers can replace the double mark-up with a single mark-up and so allows lower prices.40

Indeed, the potential for anti-competitive harm as a result of weak foreclosure is predicated on the internalization of a pricing externality and so an incentive to charge lower prices. Any discussion recognizing the potential for harm must also consider the beneficial effects of the source of that harm.

Similarly, non-horizontal mergers can, in many circumstances, reduce transaction costs. Where firms contract on an arm’s-length basis as independent firms, their interests may not be fully aligned. So-called “moral hazard” problems can arise in vertical relationships, i.e., conflicts of interest between manufacturers and retailers as regards promotions, advertising, investment in more professional sale forces, etc. Minimizing

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37 See in particular ¶¶ 52-56 (vertical mergers) and ¶¶ 113-116 (conglomerate mergers).

38 See Report by the Economic Advisory Group on Competition Policy, Non-horizontal Mergers, August 17, 2006, p.5. (“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).”). Available at http://ec.europa.eu/comm/competition/mergers/legislation/non_horizontal_guidelines.pdf.


40 This is because the integrated monopolist takes into account the positive effect on the demand of product B of a reduction in the price of product A, and vice versa. This positive externality is disregarded by each of the two single-product monopolists.
moral hazard problems requires the conclusion of often-complex contracts, as well as building in certain incentives to make sure that each side’s interests are aligned to the extent possible, e.g., the supplier may wish to link discounts to demonstrable effort by the wholesaler/retailer in pushing its products. But these contracts are often hard to write, as well as to monitor and enforce. (Such contracts may also be illegal under Article 82 EC if a firm has market power). Vertical integration may be an efficient solution in these circumstances, since it more closely aligns the incentives at both stages of production and avoids the need to build risk factors and enforcement costs into contracts.41

In fairness to the Commission, the Draft Guidelines do make clear that the ultimate concern in non-horizontal merger cases is consumer harm (¶ 16). They also make clear that non-horizontal mergers “are generally less likely to create competition concerns than horizontal mergers” (¶ 11) and that they provide “substantial scope for efficiencies” (¶ 13). The main types of efficiencies are also mentioned.

But these statements are not followed up to any large extent in the assessment that follows, or given any real context or order of importance. In particular, there is virtually no general discussion of the “substantial…efficiencies” typically generated by non-horizontal mergers, with the majority of text devoted to when foreclosure concerns are likely to be present. In other words, the emphasis appears to be the wrong way around and much greater prominence needs to be given to the general thesis that non-horizontal mergers have well-documented efficiencies in many situations. Indeed, some commentators would go as far as to say that there should be a presumption that the efficiencies put forward give rise to a pro-competitive outcome unless it can be demonstrated otherwise.42 It is unlikely as a practical matter that the Commission would be prepared go this far. But much more needs to be said about the basic point that non-horizontal mergers generally have a much stronger pro-competitive rationale than horizontal mergers.

5. Assessing Efficiencies In Non-Horizontal Mergers

In addition to failing to give sufficient attention to the fundamental point that non-horizontal mergers often confer a net benefit on consumers (even if rivals are foreclosed), the Draft Guidelines’ explanation of the conditions for proving efficiencies is somewhat limited. Additional explanation and comment would be useful since non-horizontal merger efficiencies are generally more complex to evaluate than horizontal merger efficiencies. Whereas most horizontal mergers create marginal cost efficiencies due to

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41 For an overview of the costs and benefits of vertical integration, see D.W. CARLTON and J.M. PERLOFF, MODERN INDUSTRIAL ORGANISATION, 4th ed, (Boston, Pearson Addison Wesley, 2005), pp.396-400. Vertical integration can also remove inefficiencies associated with independent manufacturers and retailers (so-called “hold-up” problems). For example, a manufacturer may be reluctant to invest in training the sales force of its retailers because part of the knowledge transferred to them may be used to promote the sales of competitors rather than its own. Vertical integration largely removes such concerns.

increased economies/lower costs, efficiencies in non-horizontal mergers are less direct because they result from combining complementary activities. Moreover, many non-horizontal merger efficiencies are non-price related, such as better coordination of production and distribution, and therefore harder to quantify and trade off against anticompetitive effects. The Draft Guidelines’ analysis could therefore be improved in a number of ways.

First, on the most important efficiencies, the Draft Guidelines would benefit from more detailed guidance on the factual settings in which those efficiencies are likely to be present or absent. For example, double mark-ups are more of a problem (and therefore more important as an efficiency in non-horizontal mergers); the higher the mark-up, the greater the market price elasticity.\footnote{Id., p.106.} In contrast, double mark-ups are less of an issue where the upstream firm can price discriminate (e.g., using contractual techniques such as two-part tariffs \textit{(i.e.,} initial lump sum payment plus fee per use)). Certain businesses may also be organized along completely separate functional units or deal with each other on essentially an arm’s length basis. In such cases, a vertical merger may not reduce double mark-ups at all.

A similar level of detail would be needed to assess the other principal efficiencies that arise from non-horizontal mergers, \textit{e.g.}, improvements in production efficiency, preventing free riding, and reducing transaction costs. It may also be appropriate in certain instances to distinguish between vertical and conglomerate mergers in this regard, since the circumstances in which efficiencies are likely to materialize may differ somewhat depending on the type of merger at issue.\footnote{For a detailed discussion of the circumstances in which various non-horizontal merger efficiencies are likely to materialize, and for the differences between vertical and conglomerate mergers in this regard, see Report prepared for DG Enterprise & Energy, \textit{The Efficiency-Enhancing Effects of Non-Horizontal Mergers} (RBB Economics). at 108-118 (2005).}

Second, it is sometimes argued that the competitive effects of non-horizontal merger efficiencies cannot be analyzed in the same way as horizontal mergers.\footnote{See Report prepared for DG Enterprise & Energy, \textit{The Efficiency-Enhancing Effects of Non-Horizontal Mergers} (RBB Economics), at 105 (2005).} In particular, it is argued that in non-horizontal mergers the anti-competitive effects have the same source as the pro-competitive effects and cannot therefore be traded off against each other like for like. For example, in a conglomerate merger involving bundling, the efficiencies from bundling will be the same source as the harm to rivals. (Indeed, the greater the (weak) foreclosure, the greater the likely efficiencies.) In contrast, in horizontal merger cases, the impact of marginal cost savings on pricing incentives can be readily assessed separately from any reduction in competition.\footnote{\textit{Id.}} Given these conceptual differences, more guidance would be welcome on the assessment of efficiencies in non-
horizontal merger cases where the source of the efficiency and the alleged harm are the same. In these circumstances, a more unified assessment of pro-competitive and anti-competitive effects is required.

Finally, the Draft Guidelines would benefit from specific guidance on the principles that will be applied in assessing when the existence of less restrictive contractual alternatives would lead to the reject of a non-horizontal merger defense. This issue is much more important in the case of non-horizontal mergers, since there will be contractual solutions short of a full merger in many cases, e.g., two-part tariffs, contracts with built-in incentives to reduce moral hazard and hold-up problems, etc.

The more practical issue however – not addressed in the Draft Guidelines – is the standard that the Commission will apply to assessing the feasibility of the merging parties making a contract that would achieve similar efficiencies to a merger. Some useful guidance is set out in this connection in the Commission’s Article 82 EC Discussion Paper, which states that the less restrictive alternative should: (1) take “into account the market conditions and business realities” facing the merging parties; (2) not be “merely hypothetical or theoretical alternatives;” and (3) be “reasonably clear” and “realistic and attainable” alternatives. Thus, evidence that the merging firms had made less restrictive contracts in the past, that other firms in an analogous market position had done so, or that there were realistic prospects of making such agreements would presumably be required at a minimum. Proportionality is a much more important issue in practice in the case of non-horizontal mergers, since they will often be the option of making a contract that would substantially achieve the same efficiency. Guidance on how this issue will be assessed in practice is therefore important.

For certain types of efficiencies, there might also be a presumption the efficiencies are more easily realized by merger than by contract. This applies for example to economies of scope and scale. Vertical integration and tying may give rise to both economies of scale and scope in production and distribution. While some argue that there is no reason a priori why products that are jointly produced should necessarily be sold together, this misses the fact that there may be significant diseconomies of scope in producing multiple separate products (e.g., increased fixed and variable costs of production).

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6. Need for greater coordination between principles of *ex ante* and *ex post* control

A key feature of non-horizontal merger cases involving foreclosure through strategic conduct is that the conduct in question should, if it occurs, normally be challengeable *ex post* under the laws that control abusive unilateral conduct (e.g., Article 82 EC). There has of course been a long-standing debate on whether this circumstance should lead to non-horizontal mergers being presumed legal and assessed only under *ex post* competition laws. But this debate is now largely academic following confirmation by the Community Courts in *Tetra Laval/Sidel* and *GE/Honeywell* that the Commission does not, in its merger control function, need to analyze in detail whether the conduct in question would be sanctionable under abuse of dominance laws. Only if its illegality is very clear and capable of easy detection and remedy does *ex post* control come into play.50

It is nonetheless important that there should be an integrated approach towards the *ex ante* assessment of non-horizontal issues under merger control laws and *ex post* conduct of a similar nature under abuse of dominance laws. A number of points require consideration in this connection. Some of these points admittedly go beyond the text of the Draft Guidelines and require consideration of its implications for other areas of EU competition policy raising similar issues. But they are no less important for that.

First, the approach to non-horizontal mergers as outlined in the Draft Guidelines and the existing approach to unilateral conduct having similar effects under Article 82 EC (and by implication, national laws) is not entirely coherent as the law stands. Article 82 EC places significant restrictions on certain types of vertical restraints imposed by dominant firms. For example, exclusive dealing and conditional rebate schemes by dominant firms have been heavily circumscribed. The Community Courts have suggested

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50 In essence, the judgments held that the Commission does not need to examine in detail whether the leveraging conduct would also constitute an abuse of dominance under Article 82 EC (although behavioral commitments not to engage in certain types of abusive leveraging conduct should be taken into account in assessing the need for a prohibition decision). See Case T-5/02, *Tetra Laval BV v Commission* [2002] ECR II-4381, confirmed on appeal in Case C-12/03, *Commission v Tetra Laval BV* [2005] ECR I-987. See also Case T-210/01, *General Electric Company v Commission* [2005] ECR II-nyr where, contrary to the Court of Justice’s judgment in *Tetra Laval*, the Court of First Instance appeared to impose a stricter burden on the Commission. The Court of First Instance held that the Commission must, in principle, take into account the potentially unlawful, and thus sanctionable, nature of certain conduct as a factor which might diminish, or even eliminate, incentives for an undertaking to engage in particular leveraging conduct. However, its appraisal should not require an exhaustive and detailed examination of the rules of the various legal orders responsible for applying Article 82 EC. Thus, where the Commission, without undertaking a specific and detailed investigation into the matter, can identify the unlawful nature of the conduct in question under Community law, it must take account of it in its assessment of the likelihood that the merged entity will engage in such conduct (¶¶ 73-75). As noted, this standard appears stricter on the Commission than the Court of Justice’s findings in *Tetra Laval*. For recent merger decisions applying this case law, see Case COMP/M.3696 *E.ON/MOL* (Hungarian energy regulator commented on difficult of *ex post* control of non-discrimination obligations under domestic law) and Case COMP/M.3440 *EDP/ENI/GDP* (difficulties of monitoring and enforcing behavioural commitments justified *ex ante* merger control).
for example that exclusive dealing by dominant firms is “in principle” not permitted\(^5\) and has applied similar rules to market share or requirements contracts.\(^5\) Conditional rebate schemes that apply individualized all-unit discounts have also been, for all practical purposes, subject to a *per se* illegality rule.\(^5\) These strict rules would be relaxed somewhat under the proposals in the Commission’s Article 82 EC Discussion Paper but it remains to be seen what the Commission’s final position will be.

This state of affairs is unsatisfactory and leads to a certain lack of overall coherence in EU competition policy. A strict policy against certain forms of vertical restraint imposed by dominant firms likely encourages firms to choose vertical integration over (potentially unlawful) arm’s-length contracts. And yet under the approach outlined in the Draft Guidelines, such mergers would generally be looked at favorably. It seems odd, as a matter of policy, that less restrictive arrangements such as contractual arrangements should be treated more harshly than outright mergers.

This also gives rise to something of an irony. When considering efficiencies in the case of non-horizontal mergers, one condition is that less restrictive arrangements such as contractual arrangements would not be an effective alternative. But so long as certain forms of vertical restraints by firms with market power are heavily circumscribed under Article 82 EC and analogous national laws, it may be open to merging parties to argue that a merger is the only effective option. All in all, a more coherent overall policy is clearly required.\(^5\)

A second related point is that a strict policy on vertical restraints applied by dominant firms may lead to a large number of mergers that, because of their small size


\(^5\) *Hoffmann-La Roche*, id.

\(^5\) See, e.g., L Gyselen, “Rebates: Competition on the Merits or Exclusionary Practice?” Speech at 8th EU Competition Law and Policy Workshop, European University Institute, June 2003 (“The EC Commission has...followed pretty much of a per se approach” (in the area of loyalty discounts)). See also *Michelin*, OJ 2002 L 143/1, ¶ 216, 263 (“An undertaking in a dominant position cannot require dealers to exceed, each year, their figures for the previous years and thus automatically increase its market share.”). See also *Soda Ash/Solvay*, OJ 1991 L 152/21, ¶ 51 (“What is important is that the terms of sale of the dominant supplier make it financially attractive for the customer to take its supplies exclusively or mainly from it. The precise means by which this result is achieved are immaterial.”).

\(^5\) See Report by the Economic Advisory Group on Competition Policy, *Non-horizontal Mergers*, August 17, 2006, p.5. (“Non-Horizontal Guidelines should be consistent with other Guidelines/Notices/Green Papers...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).”) at 7. Available at http://ec.europa.eu/comm/competition/mergers/legislation/non_horizontal_guidelines.pdf.
and/or lack of competitive overlap, do not require pre-approval under mandatory merger control laws. Thus, another effect of a lack of overall coherence in competition policy in this area is that it may encourage vertical mergers with substantial long-term anti-competitive effects that, however, escape antitrust review. This could, for example, have major implications for distribution arrangements at a national level and lead to uncompetitive downstream markets.

Finally, how the Commission approaches exclusionary conduct in its Article 82 EC review will have important implications for the treatment of the issue of incentives in non-horizontal merger foreclosure cases. On the one hand, if the Commission opts for more complex rule-of-reason type rules to analyze exclusionary conduct, which seems likely based on the Commission’s Article 82 EC Discussion Paper, then, it will be more difficult for the merging parties to argue that the illegality of the strategic conduct is so clear as to act as a disincentive to engage in it. In contrast, if relatively simple bright-line rules are adopted, then the incentives to engage in anticompetitive leveraging conduct will probably be reduced.

There are of course certain inevitable differences between *ex ante* merger control of non-horizontal mergers and *ex post* control of strategic conduct under Article 82 EC and analogous national laws. Apart from the obvious distinction between *ex ante* and *ex post* methods of control, the substantive test under the EU Merger Regulation is now broader than the dominance threshold that applies under Article 82 EC (and which previously applied under the EU Merger Regulation). As such, the EU Merger Regulation is in principle capable of capturing a broader range of strategic conduct arising in the context of non-horizontal mergers that would have pricing effects falling short of creating or strengthening dominance. These differences probably only affect a handful of cases, however, and the more important objective is to ensure greater overall consistency in approach to principles underlying *ex ante* and *ex post* control in cases where competitive harm is said to result from strategic conduct.

### F. Conclusion

The Draft Guidelines are, on the whole, to be very much welcomed. They represent an intellectually ambitious effort in a difficult area in which past Commission practice has been partly criticized by the Community Courts and other stakeholders. In broad terms, the Draft Guidelines set out a coherent economic framework for the assessment of non-horizontal mergers, as well as a series of structured conditions for establishing competitive harm. As such, they respond to the principal criticisms of past Commission practice in this area.

At the same time, however, the Draft Guidelines do not treat in detail a number of fundamental points or fail to give them appropriate emphasis. This may, in part, be a function of the fact that the Draft Guidelines have to straddle a body of decisional practice and jurisprudence that itself points in somewhat different directions. But it is nonetheless important that the vestiges of past practice that have been most criticized should be removed to the extent possible.
The most important points not satisfactorily addressed in the Draft Guidelines are as follows: (1) that most non-horizontal mergers raise no issues, with foreclosure theories only applying in exceptional circumstances; (2) that the market share thresholds in the Draft Guidelines appear unduly cautious; (3) the need to articulate more practical benchmarks on the degree of rival foreclosure required (i.e., permanent market exit or marginalization) and how this should be assessed; (4) developing a much stronger affirmative case on the notion that foreclosure concerns will often be offset by overall, or at least short-term, price and other benefits for consumers; and (5) more practical guidance on the application of the conditions for the assessment of non-horizontal merger efficiencies.

As things stand, the failure to emphasize these basic points in the Draft Guidelines could have the perverse effect of increasing the Commission’s workload as notifying parties and complainants seek to develop complex theories that, on a quick scan analysis, would be wholly unlikely to apply to the case at hand. Redressing this imbalance by developing a stronger general framework on the consumer benefits of non-horizontal mergers, and how such benefits should be off-set against foreclosure concerns, would be important to maximize the overall usefulness of any final set of guidelines.