THE REDISCOVERY OF VERTICAL MERGER ENFORCEMENT?

BY PAUL JOHNSON & ANTHONY GAMBLE[1]

 

1 Paul Johnson, Of Counsel, Baker McKenzie, Brussels and Anthony Gamble, Senior Associate, Baker McKenzie, London.

I. INTRODUCTION

Vertical transactions were for a long time a neglected area of merger control. Out there, but rarely, if ever, grabbing the attention of authorities or practitioners, let alone the broader public.

This is arguably a result of competition authorities being heavily influenced by the Chicago School of Economics' ("Chicago School") theories on vertical merger enforcement, particularly those of Robert Bork, whose theories implied that harm to competition as a result of a vertical transaction was highly unlikely.

However, this position now appears to be changing; the theories of the Chicago School are increasingly being challenged and competition authorities are rediscovering vertical merger control enforcement. One could argue that this shift in approach was needed. As the wider economy changes, economic theory evolves and the approach and analytical tools used by competition authorities should evolve as well.

With a focus on vertical merger control enforcement by the European Commission ("Commission"), this article briefly examines the Commission's approach to vertical mergers, the academic and policy debate relating to vertical merger control, and the practical implications for competition authorities grappling with these issues. Specifically, we consider that competition authorities should ensure that an appropriate assessment of vertical issues occurs during the pre-notification process. They should also undertake the necessary types and appropriate level of economic analysis, review internal documents and introduce/increase the use of screening. This should allow cases that raise no issues (or only a potential technical issue with limited practical risk) to proceed without the requirement to open an in-depth investigation.

II. THE COMMISSION'S APPROACH TO VERTICAL MERGERS

The basic legal test applicable to vertical mergers is set out in the EU Merger Regulation:[2] there must be a significant impediment to effective competition ("SIEC") in order for the Commission to be able to prohibit a deal, which is the same test that applies to horizontal mergers.

However, while the legal test is the same, the extent of the review undertaken by the Commission differs depending on whether the parties' activities horizontally overlap or are vertically related. The concerns that are the focus of vertical merger enforcement in the European Union are set out in the Commission's Non-horizontal Guidelines.[3] In brief, vertical theories of harm typically focus on actual or potential rivals' access to supplies or markets being hampered or eliminated ("anti-competitive foreclosure"),[4] and/or a change in the nature of competition that enables or facilitates coordination between competitors ("coordinated effects"). These concerns are balanced against a recognition that vertical mergers are generally less likely than horizontal mergers to result in an SIEC. This is because vertical mergers (generally) do not entail the loss of direct competition between merging firms in the same market and they may provide substantial scope for efficiencies/pro-competitive effects, particularly through the internalization of double marginalization.

The balancing act between the pro- and anti-competitive effects of vertical mergers has resulted in the Commission treating vertical mergers (in general terms) more favorably than horizontal mergers, and this same approach is taken in virtually all other major competition law jurisdictions.

III. REDISCOVERING VERTICAL MERGER ENFORCEMENT: THE ACADEMIC AND POLICY DEBATE

A. The Chicago School

The Commission's approach to the assessment of vertical mergers has in part been influenced by the Chicago School of economic thought, which provided a theoretical underpinning for a more relaxed approach to enforcement.

---

2 https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32004R0139&from=EN.

3 https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52008XC1018(03)&from=EN.

4 There may also be concerns about "information sharing" as a result of the vertical combined entity having access to competitively sensitive information about downstream or upstream competitors as a result of the vertical integration.

Specifically, under a set of arguably extreme/unrealistic assumptions,[5] the Chicago School considers that any intervention in vertical mergers is irrational for the following reasons: (i) any foreclosure of rivals is merely a rearrangement of supplier-customer arrangements that is neutral in effect; (ii) a monopolist would not gain from a vertical merger by being able to foreclose competitors and leverage market power from the monopolized market into a vertically related market (the "single monopoly profit theory"); and (iii) vertical mergers are by their very nature efficient (e.g., through the internalization of double marginalization) such that they must be pro-competitive.

B. Past Enforcement Practice

Consistent with the Chicago School's view, past enforcement practice seems to indicate that dealmakers brokering a vertical merger should rarely have to lose sleep over the risk of authorities prohibiting a deal on competition law grounds. For example, national competition authorities responding to the International Competition Network's recent Vertical Mergers Survey reported that vertical mergers accounted for only 1 in 10 cases in which they intervened.[6] Indeed, there have been very few prohibition decisions by the Commission in vertical transactions since the establishment of the bloc's merger control in 1990.[7] Moreover, where vertical concerns have been raised and have resulted in a remedy in order to avoid a Phase II investigation or a prohibition, they have been far more likely to be behavioral, i.e., the merging parties pledging to conduct their future business in a certain way, which is arguably a lower level of intervention.

This apparent lack of focus on vertical mergers is further evidenced by the EU and U.S. merger control guidelines. The Commission published guidelines on the assessment of horizontal mergers in 2004,[8] whereas the non-horizontal guidelines were not published until 2008.[9] The situation in the United States is more extreme; the current non-horizontal guidelines were published in 1984, and are now arguably out of date with respect to analysis, relevant evidence, and best practices.[10]

C. A Change in Approach

Despite the Chicago School's apparent influence in enforcement practice, in recent years its views have been increasingly seen as out of step with the shift in modern economic theory to more realistic assumptions (e.g., taking into account conditions of imperfect competition). In particular, the presumption that vertical mergers are likely to result in efficiency benefits, and that the competitive harms are either unlikely or too speculative to be taken into account, is increasingly being challenged by new economic thinking.

Questions about the correct approach to enforcement are increasingly coming to the fore at a time when there is rising concern about high concentration levels in many key markets,[11] the economic implications of new types of markets and business models, and the increasing prevalence of barriers to entry derived from technology and network effects.

Reflecting the mounting questions about the Chicago School and the correct approach to enforcement, competition authorities are starting to exhibit a heightened level of interest in vertical mergers and 2017 in particular saw a resurgence in significant vertical merger cases. The ongoing *AT&T/Time Warner* merger in the United States is the most high profile of these,[12] but there have also been several notable investigations

---

5 For a detailed critique of the Chicago School approach, see Salop, S.C. (2018) *Invigorating Vertical Enforcement,* The Yale Law Journal, Vol 127(7).

6 http://icn2018delhi.in/images/ICN-survey-report-on-vertical-mergers-17-03-18.pdf.

7 Most of these decisions have been in the telecommunications and television industries – see for example Case IV/M.469, *MSG Media Service;* Case IV/M.490, *Nordic Satellite Distribution;* Case IV/M.553, *RTL/Veronica/Endemol;* Case IV/M.993, *Bertelsmann/Kirch/Premiere;* and Case IV/M.1027, *Deutsche Telekom/BetaResearch*.

8 https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52004XC0205(02)&from=EN.

9 https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52008XC1018(03)&from=EN.

10 It is unclear yet whether these guidelines will be updated during the current U.S. Administration.

11 For example, the European Parliament has expressed its concern at the level of concentration in some sectors, such as the chemical sector, in light of recent mergers: http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P8-TA-2017-0027+0+DOC+XML+V0//EN.

12 The ruling in this case (which allowed the transaction) is now subject to appeal by the U.S. Department of Justice.

in the EU, including the Commission's prohibition of the merger between Deutsche Börse and the London Stock Exchange.[13] At EU Member State level (focusing on the UK by way of example), the UK Competition and Markets Authority ("CMA") prohibited (and required the unwinding of) the completed acquisition by Intercontinental Exchange ("ICE") of Trayport, due to concerns that ICE's ownership of Trayport's trading platform would reduce competition between ICE and its competitors in the wholesale energy market.[14, 15] The CMA also cleared at Phase II the supermarket Tesco's acquisition of Booker,[16] a groceries wholesaler, following consideration of at least two different vertical foreclosure theories of harm.[17]

IV. REDISCOVERING VERTICAL MERGER ENFORCEMENT: PRACTICAL IMPLICATIONS

Clearly, to the extent that the Commission and the national competition authorities of EU Member States neglected vertical merger enforcement previously, we are now seeing vertical mergers return to the fore. Given the increase in enforcement activity, we consider how the Commission (and competition authorities in general) could improve its processes with respect to mergers that contain vertical aspects (this is likely to be particularly important in cases where the attention of the Commission and the parties might be focused upon horizontal overlaps). In summary, we consider the need for the following: (i) a heightened focus on vertical issues in pre-notification; (ii) undertaking the necessary types and appropriate level of economic analysis; (iii) extending the use of internal documents; and (iv) introducing/increasing the use of screening.

A. An Increased Focus on Vertical Issues in Pre-Notification

An issue that the Commission and the notifying parties face in any merger review is timing constraints, which can become a significant procedural issue if new issues occur during the merger review process. In particular, if the Commission continues to have "serious doubts" based on its concerns at the end of its Phase I review, including concerns raised by a vertical relationship, notifying parties face a difficult choice: they can offer the Commission remedies to address the "serious doubts" or let the investigation go to Phase II and try to dispel the anti-competitive foreclosure or coordinated effects concerns during the course of a more in-depth investigation.

Given the time constraints of Phase I, the Commission is often not in a position to limit its concerns to specific foreclosure scenarios, or to undertake a sufficiently detailed analysis to conclude that its initial concerns (which can be raised as a result of a complaint submitted by a competitor) are ultimately unfounded.

Yet, remedies in Phase I must be "sufficient to clearly rule out 'serious doubts.'" This means the parties may have to offer more (often significantly more) than would be necessary after the Commission has had the opportunity to precisely identify the competition concerns at Phase II, or reach a conclusion that the vertical relationship ultimately does not give rise to an SIEC.

The result is that the Commission often insists that Phase I remedies are very broad-brush in nature. Of course, the option to challenge the case team's initial analysis by taking the investigation to Phase II remains, but such investigations take a long time (typically around six months) and require an enormous amount of the parties' time and resources, and may not even be permitted under the merger agreement. Moreover, vertical concerns rarely threaten to tilt the commercial rationale of a transaction, thereby lowering the incentive to fight a case on substance instead of agreeing to remedies, resulting in theories of harm being unchallenged and potentially being used as guidance for future merger reviews by the Commission.

From the Commission's perspective, the question should therefore be whether initiating a Phase II investigation to assess vertical

13 The Commission also investigated and cleared, for example, *Rolls-Royce/ITP* (Case IV/M.8242) and *Broadcom/Brocade* (Case IV/M.8314) subject to vertical conditions.

14 https://www.gov.uk/cma-cases/intercontinental-exchange-trayport-merger-inquiry.

15 Previous mergers which were prohibited as a result of vertical concerns by the UK competition authorities, include the acquisition by Bass Plc of Carlsberg-Tetley Plc see, *DTI Press Release P/97/424, 27th June, 1997; MMCReport Bass Plc Carlsberg A/S and Carlsberg-Tetley Plc No. 400 of June 1997* and the acquisition by BSkyB of Manchester United see, *DTI press release, 9th April, 1999, Monopolies and Mergers Commission report on the proposed merger of British Sky Broadcasting Group Plc and Manchester United Plc, April 1999(Cm 4305).*

16 https://www.gov.uk/cma-cases/tesco-booker-merger-inquiry.

17 The CMA also investigated and cleared at Phase I a subsequent similar vertical transaction consisting of the acquisition by the Co-operative Group (a retailer) of Nisa (a wholesaler): https://www.gov.uk/government/news/cma-clears-co-op-nisa-merger.

foreclosure concerns is always the right policy choice. After all, it's not just the notifying parties that have to invest resources, but the Commission as well. Why not invest additional but limited resources during the pre-notification period to bottom out concerns about issues raised as a result of a vertical relationship?

1. Assessment of the Ability and Incentive to Foreclose

The benefits of considering vertical issues in more detail during the pre-notification process are particularly apparent with respect to the examination of the incentive to foreclose and efficiency arguments.[18]

Any assessment as to the incentive to foreclose necessitates the gathering of margin data and the assessment of profits based on assumed price increases or restrictions of supply post-merger. This can potentially be for 31 EEA Member States (or even more splits if the relevant geographic market is defined as regional in scope). This process can be time-consuming and also raises issues when competition authorities review large global transactions, particularly those that are horizontal in nature but include limited vertical concerns. Specifically, these transactions could give rise, on a technical and economic basis, to the merged parties having the ability and incentive to foreclose when in reality any foreclosure is likely to be of low risk.[19] As a result, in such circumstances, and particularly in cases where the vertical issue only becomes live during the Phase I review, it can be very difficult to dispel such concerns.

Moreover, even with a full set of data, incentives to foreclose are not always clear cut and will clearly differ depending on market structure (e.g., a merger that is likely to result in a single dominant firm or an oligopolistic market with barriers to entry will have different incentives to foreclose as opposed to a perfectly competitive market). The market structure also has implications with respect to the single monopoly profit theory and the assumption that no additional market power can be gained from a vertical merger, which often falls away in a more typical situation where neither merging party has a monopoly (or even an oligopolistic position) protected by entry barriers. Therefore, countering the case team's assumption of there being an incentive to foreclose often requires an (econometric) analysis of whether the potential foreclosure scenarios would be profitable. As set out above, with the historical economic models being increasingly challenged, this assessment becomes increasingly difficult.

2. Efficiencies

Similarly, with respect to efficiencies, the initial assumptions around the elimination of double marginalization are also being increasingly challenged by both modern economic thinking and competition authorities on the basis that any double marginalization is either significantly reduced, or even entirely eliminated, by way of competitive contract negotiations. A risk therefore exists that vertical mergers are just as likely (or unlikely) to give rise to intrinsic harm as horizontal mergers and, as such, in order for authorities to reach an accurate assessment of the risk to competition, they should be devoting sufficient time to these issues upfront in order to ensure that they are able to reach a robust conclusion in Phase I.

Although the notifying parties have better access to the relevant information, they have the burden of producing the evidence to assess any efficiency benefits. In order to do so, they require sufficient time to produce such an assessment, particularly in cases which may be predominantly focused on horizontal overlaps. Ideally, this initial assessment should occur during the pre-notification process in order to steer data gathering.

---

18 In contrast, absent existing contractual relationships with competitors, the European Commission finds it fairly easy to establish that a merged entity will at least have the ability to engage in foreclosure (and a review of Phase II decisions involving vertical concerns suggests that there has not been a single instance since 2005 where the Commission assumed a lack of ability to foreclose).

19 For example, in a global horizontal deal, a scenario could exist in which the risk of a vertical foreclosure may occur, but given the small size of the affected market in which the merging parties may have the ability and arguably economic incentive to foreclose (e.g., a market in Norway with less than EUR 50,000 in sales) relative to the size of the proposed transaction (e.g., an EUR 5 billion takeover), and the business priorities of the merging parties (a horizontal combination), the likelihood of any planned vertical foreclosure is incredibly low. It is also worth remembering in these circumstances that intervention should only occur to protect competition, not competitors.

3. Complaints Submitted by Competitors

Finally, authorities should be wary of complaints submitted by competitors that would benefit from either a delay in a decision or a remedy offered by the parties in cases that have involved a long pre-notification process (e.g., nine months) and a complaint only being submitted by a competitor once the formal review has commenced, restricting both the notifying parties and the Commission's ability to undertake an appropriate analysis of the concerns raised.

B. Economic Analysis

The Commission should neither presume that a vertical merger in an oligopolistic market is inherently anti-competitive, nor automatically adopt a view that vertical mergers in an oligopolistic market are inherently unlikely to give rise to anti-competitive effects or that efficiency benefits will outweigh any potential anticompetitive effects. Instead, where appropriate, and if needed, modern economic tools should be used to assess transactions on a case-by-case basis.

Increasingly, new quantitative methodologies developed by economists can be used to determine the harm from foreclosure, including the following: (i) a vertical arithmetic methodology that can be used to assess whether refusal to deal would be profitable for the merged firm; (ii) the Nash Bargaining Equilibrium methodology to assess the impact of foreclosure threats on predicted negotiated prices; and (iii) the vertical gross upward pricing pressure index ("vGUPPI") methodology to assess partial foreclosure unilateral incentives to raise input prices to downstream competitors and the resulting upward pricing pressure on rivals' prices as well as the elimination or reduction of double marginalization.

C. Internal Documents

While quantitative methodologies are important and provide insight as to the likely effects of a vertical merger, they should also be combined with internal documents to understand the reality of a proposed merger, particularly where there is an arguable case that anti-competitive foreclosure would result from the transaction but in practice the parties consider that this is highly unlikely to occur. We note that the Commission and national competition authorities are increasingly requiring parties to undertake extensive document reviews. While this is imposing an increasing burden on the parties, it does have the potential to assist them in vertical cases.

D. Screening

While the EU Merger Regulation does not provide for a separate legal test for vertical transactions, the Commission could use its discretion, or introduce a *de minimis* market size screen similar to that used by the CMA, when it comes to requiring a remedy for merger clearance to be obtained in Phase I and/or the establishment of "serious doubts" and the referral of a transaction to Phase II. This additional review, in cases that merit it, would minimize the risk of parties facing the often difficult choice between arguing the case on its merits in Phase II or submitting a remedy in order to obtain conditional clearance in Phase I.

V. CONCLUSION

The Chicago School has influenced leading competition authorities and the merger control review of vertical transactions on a global scale. However, reflecting a shift in the academic debate as well as economic changes, the Commission and other competition authorities are re-discovering vertical merger control enforcement with more frequent interventions.

As the economic analysis of vertical mergers evolves, there is an increased risk of these issues arising late in the merger review process, resulting in a choice of offering a potentially unnecessary remedy to get clearance at Phase I or entering into a fight at Phase II to obtain an unconditional clearance.

Therefore, the processes and procedures of competition authorities should evolve. These changes should include an increased focus on vertical issues during the pre-notification process, undertaking the necessary types of economic analysis and document review, as well as introducing or increasing the level of screening, in order to ensure that those cases in which a genuine concern arises are challenged, whereas those cases that raise either no issues or only a potential technical issue with little practical problems are allowed to proceed, so that the efficiency of the merger review process is maintained, and painful delays and misallocation of resources can be avoided.