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Non-horizontal Mergers under the EC Merger Regulation

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General Note about the Content

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Abstract

Companies active in different levels of the supply chain (e.g. a producer and a distributor) may find it attractive to merge their businesses so that these previously independent firms will become a single entity. They may do so because of expected efficiency gains such as costs and price reductions, improvements in the quality of their products or increased variety and innovation. However, these so-called "pro-competitive" effects may not be the only reason why firms choose to merge their businesses. A merged company may be able and willing to foreclose access to supplies or markets for its rivals due to its strengthened position. Such "anti-competitive" effects may lead to reduced competition in the markets and thereby can lead to price increases of products and services to the disadvantage of consumers.

The European Commission is basically entitled to assess the competitive effects of a proposed merger with a Union-wide dimension and can prohibit proposed mergers if they are not in line with European competition law. The legal basis for European merger control is the "EC Merger Regulation" that entered into force in 2004.

To ease the application and interpretation of the "EC Merger Regulation", the European Commission in 2007 issued "guidelines on the assessment of non-horizontal mergers" that made its merger decisions more predictable.

In its merger examination the European Commission must compare the competitive conditions that would occur without the proposed merger to the competitive conditions that would prevail after the merger.

This thesis tries to illustrate how the European Commission makes such a competitive assessment from a practical standpoint. Furthermore, this thesis provides case studies when proposed mergers that involved companies active in different markets ("non-horizontal" mergers) were prohibited, because of expected likely negative effects on competition.

CONTENTS

LIST OF ABBREVIATIONS

CFI	European Court of First Instance
DOJ	U.S. Department of Justice
EC	European Community
ECJ	European Court of Justice
E.C.L.R.	European Competition Law Review
ECMR	European Community Merger Regulation
E.C.R.	European Court Reports
E.L. Rev.	European Law Review
et sqq.	and the following
EU	European Union
EuZW	Europäische Zeitschrift für Wirtschaftsrecht (European journal for business law)
I.E.L.T.R.	International Energy Law & Taxation Review
Int.T.L.R.	International Trade Law & Regulation
J.L. & Econ.	Journal of Competition Law & Economics
OJ	Official Journal of the European Union
para.	paragraph
R&D	Research and Development
RdW	Recht der Wirtschaft (Austrian journal for business law)
ref.	reference
TFEU	Treaty on the Functioning of the European Union

I. Introduction

On May 1, 2004, a new Council Regulation ("EC Merger Regulation") - setting up a new system for merger control within the EU - became effective.[1] This Merger Regulation: 1) illustrates how mergers are examined by the European Commission, 2) states the criteria for appraisal of concentrations and resulting legal consequences (Art 2 ECMR), and 3) gives definitions of merger-related terms, among other things. First of all, the difference between a "concentration" and a "merger" should be clarified. Actually, the term "concentration" is a general term that includes mergers, acquisitions, takeovers and certain types of joint ventures.[2] In the context of this paper, however, the term "merger" will have the same meaning as that of "concentration" and will describe all types of transactions.

There are basically two types of mergers: horizontal mergers and non-horizontal mergers. Horizontal mergers occur when a concentration between actual or potential competitors takes place in the same relevant market.[3] An example of a horizontal merger is the merger that occurred in 1997 between The Boeing Company and McDonnell Douglas Corporation.[4] Both Boeing and McDonnell Douglas were operating in the same relevant markets, as they were active in all aerospace sectors, namely, commercial, defence and space.

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1 Council Regulation 139/2004 of 20 January 2004, On the Control of Concentrations Between Undertakings (the EC Merger Regulation), 2004 O.J. (L 24) 1 (EC). The enactment of the Treaty of Lisbon on December 1, 2009 had no effect on the name of the EC Merger Regulation. The European Union succeeded the legal personality of the European Communities. European Community law has now become European Union law.

2 Council Guidelines on the Assessment of Horizontal Mergers Under the Council Regulation on the Control of Concentrations Between Undertakings, 2004 O.J. (C 31) endnote 5. [hereinafter Horizontal Merger Guidelines].

3 Horizontal Merger Guidelines, *supra* note 2, 5.

4 Commission Decision, Case M.877 Boeing/McDonnell Douglas, 1997 O.J. (L 336) 16.

Unlike horizontal mergers, non-horizontal mergers occur when the firms concerned are active in different markets. Non-horizontal mergers can be divided into vertical mergers and conglomerate mergers.[5]

On November 28, 2007, the European Commission adopted non-horizontal merger guidelines to ease the application and interpretation of the EC Merger Regulation on non-horizontal mergers.[6]

An example of a vertical merger is if a manufacturer (called the "upstream firm") acquires one of its distributors (called the "downstream firm"). In this example, the manufacturer is not operating in the same relevant market, as the distributor is on a different level of the supply chain.

Contrary to vertical mergers, conglomerate mergers are neither horizontal nor vertical. The European Commission's non-horizontal merger guidelines state that an example of such a merger would be when a merger occurs between companies that are active in closely related markets; that is, the merger could involve suppliers of complementary products or products that belong to the same product range.[7] For instance, a merger between a supplier/manufacturer of photocopiers and a supplier/manufacturer of ink is considered a conglomerate merger. In practice, conglomerate mergers have become rare since the movement to specialization, focusing on a main business, seems more profitable for firms.[8]

Thus far, this introduction has explained some basic terms that are fundamental to understanding the subsequent chapters of this thesis. However, as important as illustrating the

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5 Commission Notice, Guidelines on the Assessment of Non-Horizontal Mergers Under the Council Regulation on the Control of Concentrations Between Undertakings, 2008 O.J. (C 265) part I 3 [hereinafter Non-Horizontal Merger Guidelines].

6 Press Release, European Commission, Mergers: Commission Adopts Guidelines for Merging Companies with Vertical or Conglomerate Relationship (Nov. 28, 2007).

7 Non-Horizontal Merger Guidelines, *supra* note 5, part I 5.

8 GIORGIO MONTI, EC COMPETITION LAW 272 (Cambridge University Press, 2007) [hereinafter MONTI].

legal framework of merger control may be, the economic issues underlying why mergers are examined and the effects of competition, respectively, should also be kept in mind.

As set out in Article 119 TFEU,[9] the Union's general economic policies are supported "in accordance with the principle of an open market economy with free competition." In a market where effective competition is prevailing, consumers may ultimately benefit, as they are likely to: 1) pay low prices for products and services, 2) get high quality products, and share in a variety of goods, services and innovation.[10]

Nevertheless, mergers can lead to a distortion of competition when the merger creates a dominant firm that is likely to raise its prices.[11] Another negative competitive effect resulting from a decline in market competition could be the dominant firm's reduction of output or deterioration in the quality of goods and services.[12] Pursuant to Article 2 (3) ECMR, a merger "shall be declared incompatible with the common market"[13] if it "significantly impedes effective competition in the common market or in a substantial part of it."

The system of EU merger control seeks to ensure effective competition as a means to protect customers against negative competitive effects (e.g. increase in price) and ultimately seeks to improve their respective welfare.[14]

Although horizontal mergers are likely to significantly impede effective competition, this is generally not the case for vertical and conglomerate mergers. Horizontal mergers can harm direct competition between the merging firms, because they are active in the same

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9 Consolidated Version of the Treaty on the Functioning of the European Union, Mar. 30, 2010, 2010 O.J. (C 83) 47.

10 Non-Horizontal Merger Guidelines, *supra* note 5, part II 10.

11 MONTI, *supra* note 8, at 246.

12 Non-Horizontal Merger Guidelines, *supra* note 5, part II 10.

13 Since the enactment of the Treaty of Lisbon, "common market" has become the European Internal Market. The expression "common market" will nevertheless be used in this thesis as "common market," even though the ECMR has not yet adapted to the new terminology.

14 C. J. COOK AND CHRISTOPHER S. KERSE, EC MERGER CONTROL 9 (Sweet & Maxwell, 4th ed. 2005) [hereinafter COOK AND KERSE].

relevant market. Contrary to horizontal mergers, non-horizontal mergers do not occur in the same market but, as shown above, occur in different markets.[15] This does not imply that non-horizontal mergers cannot be declared incompatible with the common market by the European Commission. Competition concerns can arise when a merger leads to foreclosure of a rival's access to supplies, so-called “input foreclosure,” or when a merger gives rise to a so-called “customer foreclosure,” which will be discussed in detail in a separate chapter of this thesis.

Lastly, one must mention why firms have an incentive to merge businesses in the first place. This is primarily the case due to efficiency enhancing effects. Generally speaking, non-horizontal mergers lead to lower prices in line with consumer interests. This is often because, in a vertical or conglomerate relationship between the merging firms, a cutback in the price of one good may lead to increased demand for the other goods. For example, if a car manufacturer lowers its prices for cars, then its tire suppliers will have an increase in demand. These beneficial effects would not occur if the firms were not merged and, therefore, were under separate ownership.[16] An integrated firm may also make it possible to better coordinate product design, production processes and distribution of products.[17]

In assessing these competitive effects of a merger, the Commission must compare the competitive conditions that would occur without the proposed merger to the competitive conditions that would prevail after the merger.[18]

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15 Non-Horizontal Merger Guidelines, *supra* note 5, part II 12.

16 *Final Report by RBB Economics for the European Commission on The Efficiency-Enhancing Effects of Non-Horizontal Mergers*, at ii, (2005) [hereinafter RBB Report], *available at* http://ec.europa.eu/enterprise/newsroom/cf/_getdocument.cfm?doc_id=413.

17 Non-Horizontal Merger Guidelines, *supra* note 5, part II 14.

18 *Id*. part II 20.

Importantly, the EU merger control system is based on a mandatory system of prior notification for concentrations with a "Community dimension"[19] as provided in Article 4 (1) ECMR. Firms are supposed to notify the Commission of proposed mergers to avoid the risk of fines and having the legal validity of the transaction called into question.[20]

II. Definition of concentration

As stated in the introduction, the term "concentration" is a general term that includes transactions like mergers, takeovers, acquisitions and certain types of joint ventures. Article 3 ECMR is the legal basis for defining concentrations. On July 10, 2007, the Commission adopted new guidelines for jurisdictional issues that replace four pre-existing guidelines.[21] The adoption and consolidation of this so-called "Jurisdictional Notice" was necessary in light of the ECMR, released in 2004, that required certain amendments to be made.

Article 3 (1) ECMR states that a concentration occurs whenever a change in control, on a lasting basis, results from a transaction. Thus, a merger within the meaning of Article 3 (1) (a) ECMR would occur when two or more previously independent undertakings combine into a new undertaking and are no longer legally separate entities.[22] It is not stringently required that both entities quit their legal identities for a merger to be deemed to have occurred; it is also sufficient for one entity to continue to legally exist, as was the case in the Exxon/Mobil merger.[23] In that case, the two companies Exxon Corporation and Mobil Corporation signed an agreement and a plan of proposed merger. Pursuant to this agreement,

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19 In light of the TFEU, the "Community dimension" should now be understood as the "Union dimension."

20 COOK AND KERSE, *supra* note 14, at 6.

21 Press Release, European Commission, Mergers: Commission Adopts Consolidated Guidance Concerning Jurisdiction in Merger Control (July 10, 2007).

22 Commission Consolidated Jurisdictional Notice under Council Regulation (EC) No 139/2004 on the Control of Concentrations Between Undertakings, 2008 O.J. (C 95) 1 9 [hereinafter Jurisdictional Notice].

23 Case IV/M.1383, Exxon/Mobil, (Sep. 29,1999).

Mobil wanted to merge with a wholly-owned subsidiary of Exxon, and to have Mobil as the surviving corporation. Exxon would, in return, hold 100 percent of Mobil's issued and outstanding voting securities. This merger was finally declared compatible with the common market in 1999, and was, therefore, cleared by the European Commission.

A merger in the meaning of Article 3 (1) (a) ECMR can also occur when previously independent undertakings combine activities, resulting in the creation of a new economic unit. Issues of control may be relevant to assess the previous independence of the firms and to distinguish a merger from an internal restructuring within the group.[24]

Article 3 (1) (b) ECMR also states that an acquisition of control is considered a concentration. In this context, control means a controlling interest. It is not necessary for the concentration to result in formal creation of a parent and subsidiary company.[25]

In addition, Article 3 (4) ECMR provides that a merger can also occur when a joint venture is created that performs all the functions of an autonomous entity. A prerequisite for the joint venture to be deemed a merger is that the joint venture must continue on a lasting basis. This means that a concentration has not occurred when the joint venture only lasts for a short or definite period of time.[26] However, there have been some cases where the undetermined term “short or definite period of time” was substantiated. The creation of a joint venture between DaimlerChrysler Services AG, a member of the DaimlerChrysler group, and Deutsche Telekom AG was finally cleared by the Commission as compatible with the common market. The parties set up a joint venture, named “Toll Collect,” that was intended to establish and operate a system for collecting truck tolls on behalf of the Federal Republic of Germany. The parties signed an operating agreement with the Federal Republic of Germany

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[24] Jurisdictional Notice, *supra* note 22, pt. B(I) 10.
[25] COOK AND KERSE, *supra* note 14, at 37.
[26] Jurisdictional Notice, *supra* note 22, pt. B/IV(4) 104.

that the joint venture was to be carried out on a 12-year basis. In its April 30, 2003 decision,[27] the Commission made it clear that a period of 12 years is sufficient to introduce lasting changes to the structure of the notifying parties.

In another case[28] the Commission held that a period of 10 – 15 years for a joint venture is sufficient to fall under the merger control system. A period of only 3 years, however, is too short to fall under Article 4 ECMR.[29]

III. Community/Union Dimension

Article 1 (1) ECMR provides that the merger control system is only to be applied if concentrations have a "Community dimension."[30] In its preamble para. 10 ECMR, the Commission states that a concentration with a Community dimension only exists when the aggregate turnover of the concerned undertakings exceeds given thresholds. The term "Community dimension" does not mean that the undertakings must have their seat or their main fields of activity within the European Union; it is sufficient that they have "substantial operations" within the European Union. Thus, the Commission is entitled to examine mergers when an impact on the European Union's Internal Market, formerly the common market, may occur. This can be the case in a variety of industries; for example, the Commission can examine a merger between two firms in the computer manufacturing sector that may have a Community dimension even though the involved companies do not have their seat or main fields of activity in the European Union.[31]

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27 Case COMP/M.2903, DaimlerChrysler/Deutsche Telekom/JV, (April 30, 2003).
28 Case COMP/M.3858, Lehman/Brothers/Starwood/Le Meridien, (July 20, 2005).
29 Jurisdictional Notice, *supra* note 22, pt. B/IV(4) fn. 94.
30 In light of the TFEU, the "Community dimension" should now be understood as the "Union dimension."
31 EDURNE NAVARRO ET. AL., MERGER CONTROL IN THE EU pt. 4.12 (Oxford University Press, 2nd ed., 2005).

The reason for setting up a system to assess the Community dimension of a proposed merger is simply to distinguish the competence of the Commission from the competence of a national competition authority. If the proposed merger falls below the given thresholds, then the merger has no Community dimension and will, consequently, be assessed by a national authority if the merger has a national dimension.[32]

Article 1 (2) ECMR provides turnover thresholds. Pursuant to Article 1 (2) (a) ECMR, a concentration shall have Community dimension when:

> *"the combined aggregate worldwide turnover of all the undertakings concerned is more than EUR 5.000 million and*
>
> > *(b) the aggregate Community-wide turnover of each of at least two of the undertakings concerned is more than EUR 250 million,*
> >
> > *unless each of the undertakings concerned achieves more than two-thirds of its aggregate Community-wide turnover within one and the same Member State."*

This means that the purpose of the first threshold - worldwide turnover of greater than EUR 5 billion - is to assess the overall dimension of the respective firms. The second threshold - Community-wide turnover of greater than EUR 250 million - seeks to measure whether the merger includes a minimum level of Community-wide activities. Lastly, the purpose of the two-thirds rule is to separate barely domestic transactions from Community jurisdiction.[33]

Article 1 (3) ECMR provides more thresholds in the event that a merger falls below the thresholds in para. 2, but still may have a significant impact in at least three Member States. In terms of a unification, the rule aims to have the merger examined under one single

[32] *Id*. at 4.01 - 4.02.
[33] Jurisdictional Notice, *supra* note 22, pt. C/I 125.

competition authority, the European Commission, rather than by three different competition authorities that each employ unique national laws.[34]

Nevertheless, if a merger falls below the thresholds and is set to be assessed by national authorities, Article 22 ECMR provides Member States with the opportunity to request that the Commission examine the merger if, although not having a Community dimension, it will still affect trade between Member States and could have a potentially serious impact on competition within the Member State's territory.

Another approach is defined in Article 4 (5) ECMR, which allows for undertakings or persons to inform the Commission that the proposed concentration should be examined by the Commission. A precondition is that the concentration should have no Community dimension and should be capable of examination under the respective national competition laws of at least three Member States. As set forth in subparagraph 3, if none of the involved Member States express disagreement with the proposed measure, then the Commission has the power to decide whether it will examine this concentration or will refer it to the competent Member States.

As mentioned above, it is important to keep in mind the turnover thresholds in order to properly distinguish the Commission's competences from the national competition authorities' competences. For this purpose, Article 5 ECMR gives guidance on the calculation of turnover. It provides that aggregate turnover,

> "*shall comprise the amounts derived by the undertakings concerned in the preceding financial year from the sale of products and the provision of services falling within the undertakings' ordinary activities after deduction of sales rebates and of value added tax and other taxes directly related to turnover [...].*"

[34] *Id*. pt. C/I 126.

This definition means that only the "net" turnover is taken into account. By calculating turnover in this way the Commission wants to ensure that the real economic strengths of the undertakings are evaluated.[35] The aim of the calculation-of-turnover rule is to reflect only transactions with third parties such that internal revenues are ignored.[36]

More detailed information about calculation of turnover or about Community dimension can be found in the Jurisdictional Notice.

IV. Market share and concentration levels

Market shares and concentration levels are an important indication of a possible anti-competitive risk. They provide important information about market power and competitive significance of the parties involved in a merger compared to competitors.[37] In its non-horizontal merger guidelines, the Commission states that if a merger creates a post-merger entity that holds less than a 30 percent market share in each relevant market, then such a merger will not pose competition concerns. Another precondition for the Commission to clear a merger is there must be a post-merger HHI below 2000.[38]

The adoption of these measures – namely, the 30 percent threshold and the HHI test - from horizontal mergers to non-horizontal mergers by the Commission in its non-horizontal merger guidelines has triggered some criticism. It has been argued that the 30 percent market

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[35] *Id*. pt. IV 164.

[36] BELLAMY & CHILD: EUROPEAN COMMUNITY LAW OF COMPETITION pt. 8.062 (Peter Roth & Vivien Rose eds., Oxford University Press, 6th ed., 2008) [hereinafter BELLAMY & CHILD].

[37] Non-Horizontal Merger Guidelines, *supra* note 5, pt. III 24.

[38] Herfindahl-Hirschman-Index. The HHI is a measure of the size of firms in relationship to the industry and an indicator of the amount of competition amongst them. It is defined as the sum of squares of the market shares of each individual firm. The index's range is between 0 and 10.000, moving from a very large amount of very small firms to a single monopolistic producer. More information available at: http://en.wikipedia.org/wiki/Herfindahl_index.

share threshold is too low and that the HHI test should be dropped, because it is less relevant in assessing likely competitive effects of non-horizontal mergers.[39]

Another reason why market share is not always meaningful as an evaluation method is the fact that in unstable markets, where a lot of innovation is taking place, a more comprehensive market analysis is needed in order to properly assess market power.[40]

V. Vertical mergers

A. Efficiency enhancing effects of vertical mergers

As shown in the introduction, vertical mergers can lead to pro-competitive and anti-competitive effects, both of which the Commission is committed to balancing in order to make an appropriate merger decision. The focus of this chapter is on the motivation behind why firms choose to merge businesses. Merging businesses can lead to efficiency gains and, consequently, may be the cause of incentives that must be demonstrated. Not only are there often efficiency gains through costs and price reductions, but there are also improvements in quality or increased variety and innovations that should be considered. One can define four groups of sources for efficiencies:[41]

– Increased pricing efficiency

– Improved productive efficiency

– Prevented profit expropriation

[39] Simon Bishop, *(Fore)closing the Gap: the Commission's Draft Non-horizontal Merger Guidelines*, 29 EUR. COMP. L. REV. 1, 1 (2008); *see also* Alex Petrasincu, *The European Commission's New Guidelines on the Assessment of Non-Horizontal Mergers – Great Expectations Disappointed*, 29 EUR. COMP. L. REV. 4, 222 (2008).

[40] MONTI, *supra* note 8, at 251.

[41] RBB Report, *supra* note 16, at 21.

– Incomplete contracts and transaction costs

1. Increased pricing efficiency

If two independent firms in a supply chain sell products, they will not sell these products at the costs of production; rather, they will include a mark-up in order to make a profit. For example, a cement plant (the upstream firm) will sell its products with a mark-up to a manufacturer of ready-mixed concrete (the downstream firm), which, consequently, sells its products with an additional mark-up to consumers. The price for consumers is calculated with two mark-ups ("double mark-up effect") and the price is, therefore, generally inefficiently high. If the two firms in this example were vertically integrated, then they could coordinate prices and reduce these mark-ups. Such coordination would lead to a lower price for consumers and, as a result, to a higher demand for the products. Unlike with an independent firm, a reduction of mark-up would still be profitable to an integrated firm. Thus, a vertical merger can incentivize firms to integrate due to improved pricing efficiency.[42]

Another form of an incentive to merge firms is to avoid "input substitution." For instance, if an upstream firm has market power and charges a mark-up to its products, then it is likely that a downstream firm will have the incentive to switch to an alternative input that may be - although sold under competitive conditions - less efficient for the downstream firm's production.[43] In other words, this downstream firm may try to move away from the higher priced input supplier to a more cost-effective supplier in order to minimize its costs.[44]

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[42] *Id*. at 23.

[43] *Id*. at 37.

[44] Jeffrey Church, *Final Report for the Directorate General for Competition on The Impact of Vertical and Conglomerate Mergers on Competition*, at 19 (Sept. 2004), *available at* http://ec.europa.eu/competition/mergers/studies_reports/merger_impact.pdf [hereinafter Vertical and Conglomerate Merger Report].

As a more concrete example,[45] a manufacturer of fabric may have the choice to replace cotton with polyester. The manufacturer might try to use polyester rather than cotton, because, assuming both goods are provided at the marginal costs, the polyester is cheaper.[46] However, if polyester is sold to the manufacturer at a mark-up, because it is produced by a monopolist, then the manufacturer is more likely to buy more cotton than polyester since cotton is produced under competitive conditions and sold at cost. This falsification of production leads to an inefficient use of inputs, meaning that the same goods could be produced at lower costs.

If the two firms were vertically merged, then the integrated firm would make production decisions based on marginal costs of production. Thus, if it is more favorable to produce fabric by using more polyester than by buying cotton, then the firm would do so.[47] By virtue of vertical integration, then, the merged entity increases production efficiencies. Such a reality would not be possible if the firms were separated.

A pro-competitive effect of a vertical merger can also occur when rivals' costs are lowered as a result of the vertical integration. As shown above, vertical mergers generally lead to increased efficiency and cost-effective production for the integrated firm. As a result, an integrated firm gets access to cheaper inputs; the upstream entity reduces its mark-up on inputs, and the downstream entity is not forced to buy inputs from other firms. This will, consequently, lead to decreased demand for a rival firm's inputs at the upstream level. The rival firm is, therefore, likely to price more aggressively in order to boost input sales. As a result, it lowers prices due to the vertical integration of its competitor. This example shows

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[45] RBB Report, *supra* note 16, at 37.

[46] Marginal cost at each level of production includes any additional costs required to produce the next unit. At each level of production and time period under consideration, marginal costs include all costs that vary with the level of production; other costs are considered fixed costs. More information available at: http://en.wikipedia.org/wiki/Marginal_cost].

[47] RBB Report, *supra* note 16, at 38.

that reducing double mark-ups by merging two firms can also lead to a spill-over effect for non-integrated firms.[48]

Lastly, another source of efficiency gain is price discrimination. If a firm has some market power it may want to increase profits by charging different prices to different customers. Given the fact that different customers may have different abilities and willingness to pay for a product, a firm has the incentive to charge higher prices to those customers who will pay more than to other customers who are not willing to pay high prices or are able to switch to other suppliers. In this case, a firm, such as an upstream firm, seeks to merge with a downstream firm to affect price discrimination.[49]

For instance, assume an upstream manufacturer produces and sells virgin-aluminium parts to two downstream firms: a saucepan manufacturer and an aircraft manufacturer. Both downstream firms need aluminium for their products. While the saucepan manufacturer could use steel instead of aluminium, this is probably not the case for the aircraft manufacturer who must build lightweight aircraft. Thus, the aircraft manufacturer would be willing to pay more for the aluminium than the saucepan manufacturer. The upstream firm (producer of aluminium) may have an incentive to charge more to the aircraft manufacturer than to the saucepan manufacturer.

However, these different price policies would not be successful if the downstream firms could trade between themselves. If the saucepan manufacturer was able to resell the aluminium to the aircraft manufacturer at a lower price than the aircraft manufacturer would have to pay the upstream firm, then price discrimination would be ineffective for the aluminium manufacturer. Therefore, the aluminium manufacturer may have a strong incentive to merge with the downstream saucepan manufacturer to cut off trading between the

[48] *Id.* at 42.
[49] Vertical and Conglomerate Merger Report, *supra* note 44, at 21.

downstream firms. After the merger, the firm can charge lower prices to its downstream division, while charging higher prices to independent firms.[50]

2. Improved productive efficiency

Improved productive efficiency is another possible effect of a vertical merger such that a good can be produced more efficiently.[51] One such effect is referred to as "Economies of scope." This means that costs can be reduced if production of different goods is pooled together. A means of combining production is through technological synergies. An example is merging a pig-iron manufacturer with a steel manufacturer. Pig iron is impure raw iron that results from melting iron ore. In order to become steel, it is necessary to do additional treatments to the pig iron. By combining the production of steel and pig iron in the same factory, the molten pig iron can be employed, which spares the costs of reheating it rather than using hardened iron and melting it in another factory. By enabling production in a more cost-effective way, total production costs for the merged entity are lower than the total of the production costs of the individual firms.[52]

Firms also try to make sure that their input suppliers, like suppliers of raw materials, deliver on time. This is especially important during periods of high demand when failures in supply can lead to exorbitant damages for downstream firms. If those firms merged with their suppliers, then they would gain more control over the production process and could assure the supply. This is relevant for firms that have a so-called Just-In-Time production and distribution, meaning that no products are made or delivered until there is a demand for them.

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[50] RBB Report, *supra* note 16, at 45.
[51] Vertical and Conglomerate Merger Report, *supra* note 44, at 20.
[52] RBB Report, *supra* note 16, at 47.

These efficiencies have been considered in the airline business, where airlines merged with petroleum refiners in order to get stable supplies and prices for jet fuel.[53]

Productive efficiency is also improved when firms obtain information and coordinate activities after closing a merger. Firms may possess unique skills or market knowledge that can be better used if commonly shared.[54]

This transfer can lead to higher quality products and is, therefore, an incentive to vertically integrate firms. Exchange of information and coordination plays a vital role in different sectors, like research & development (R&D), distribution and marketing. In R&D industries, firms are often required to exchange information about technology in order for products to be compatible with each other. A prominent example is the car manufacturing industry, where car manufacturers and suppliers often closely cooperate. In distribution, an example of an incentive to exchange information would be the customization of products. Due to the fact that manufacturers and suppliers closely coordinate and adjust their products, it is possible to offer customized products, such as products that allow customers to choose most of the components (e.g. computer industry). Another source of efficiency is marketing. Basically, downstream firms, like retailers have better insights into consumers' demands than upstream firms like manufacturers. For example, in the fashion industry, a retailer is more likely to know what consumers are demanding than manufacturers. A manufacturer would, consequently, have an incentive to merge with a downstream firm in order to get access to this valuable information.

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53 *Id*. at 48.

54 MIGUEL DE LA MANO, EUROPEAN COMMISSION, FOR THE CUSTOMER'S SAKE: THE COMPETITIVE EFFECTS OF EFFICIENCIES IN EUROPEAN MERGER CONTROL 67 (Office for Official Publications of the European Communities 2002) [hereinafter MANO].

As a result of a merger, coordination and information flows between the merging parties are improved, which results in more competitive behavior from rivals due to the merged entity’s better products that make it more attractive to consumers.[55]

Another possible reason for acquiring a firm is the fact that, due to gaining control over the firm, it is possible to replace less capable managers with more successful ones. This increases productive efficiencies of the firm involved. An upstream firm merging with a downstream entity is likely to have good insights into the downstream firm's mismanagement. Although the management's performance is sometimes difficult to measure, it is nevertheless a step worth considering.[56]

3. Prevented profit expropriation

There are specific circumstances where firms are not willing to invest in certain activities, such as promotion, because other firms benefit from these activities without bearing any costs. If, for example, a downstream distributor produces advertising materials in order to boost sales, then the promotional activities do not only have a positive effect for the distributor but may also have an advertising impact on other firms, namely, competitors of the distributor. This means that, although the other competitor does not bear any advertising costs, it is likely that this competitor firm benefits from the advertising campaign for free.[57] This effect is referred to as “free riding.” As a result of such free riding effects, the distributor will think twice about whether it will invest more money in promotional activities. Consequently, the distributor or retailer might invest less money in advertising activities. Not only is the downstream firm – which invests less money – affected, the manufacturer itself is

[55] RBB Report, *supra* note 16, at 51-52.
[56] MANO, *supra* note 54, at 68.
[57] Vertical and Conglomerate Merger Report, *supra* note 44, at 284.

also affected. Usually, manufacturers have an incentive to increase the distributor's advertising campaigns in order to sell more products. However, since the manufacturer also has an incentive to prevent free riding from happening, the manufacturer may also choose to decrease advertising spending as a result of these behaviors. In addition, free riding is not limited to downstream firms; it can also occur at the upstream level. For instance, a manufacturer may train the retailers' staff ton how best to sell its products. It may be the case that the manufacturer's training activities have negative effects due to the fact that well trained personnel may boost the sale of products from other manufacturers.

There are certain environments where free riding is likely. For instance, free riding may proliferate when goods are new and technically demanding, which requires good information for consumers. Another case might be when advertising activities are necessary for firms to establish brands and enter the market.[58]

Several solutions, like a closed territorial distribution or exclusive dealing, are possible for solving the free riding problem. One solution is vertical integration, as it reduces competition at the level where free riding occurs. If the upstream manufacturer merges with a retailer, it can exclude competing retailers. The integrated retailer would not be deterred from investing in advertising activities, as the merged entity itself would directly profit, making free riding a non-issue.[59]

Other undesirable effects that can occur are referred to as “spillover effects.” Firms only have an incentive to invest in R&D if they can expect a resulting increase in profits. However, when an innovation can be easily imitated by other rivals, the researching firm is damaged, because the rival is able to gain profit even though it was not involved in R&D

[58] RBB Report, *supra* note 16, at 55.
[59] *Id*. at 56.

activities. This inefficiency can be confronted through vertical integration, which allows for better protection of product innovation. If a product is embedded in an end product, reverse-engineering is made more difficult for a rival to carry out. Vertical integration can also bring about a time advantage, such that the product is already on the market by the time the competitor can begin efforts to copy the innovation.[60]

4. Incomplete contracts and transaction costs

It is necessary in the course of business for firms to sign contracts with various other firms. However, it is simply not possible to settle every problem in detail that can occur. This is especially true for future circumstances. This problem is referred to as "incomplete contracts." Such incomplete contracts are generally associated with high costs for the firms involved, as they are required to monitor the contracted actions since the contracting parties may have an incentive to take advantage of contractual loopholes. One example of this problem is when an external researcher promises to engage in research for an R&D project, and, after the contract has been signed, he reduces his research efforts and blames the failure and lack of results on bad luck. In this case, due to the fact that the two firms are independent, the affected firm has no direct rights to enforce the researcher's behavior. Instead, it has to analyze the contract with the researcher. However, if the two firms were merged, then the affected firm would have more rights; for instance, it could fire the researcher, because a normal employer/employee relationship would exist.[61]

A merger may also be useful when two firms have a specific relationship and are commercially interdependent. If a firm makes an investment that has no value to other firms,

[60] *Id*. at 59.
[61] *Id*. at 66.

then it makes the firm susceptible to exploitation. This problem is called the "hold-up" problem.[62] An example of this problem is if a manufacturer develops and produces a product that is only applicable to one client's products. In order to produce, the manufacturer has to make investments. After such investments have been made, the manufacturer is in a weak bargaining position, because it is very dependent on a client who could threaten to switch to another manufacturer. The client could take advantage of this problem and try to renegotiate supply terms and lower prices, even when prices were set before the production process began. Since the manufacturer's product is very specific, it could not sell the product to another client. As such it would have to agree to the lower price or face a useless investment. Of course, it is possible to stop such activities by drawing up a contract, but contracts will never align the interests of the two firms to the same degree as if the firms were vertically integrated. As explained above, contracts have to be monitored and deviations have to be sanctioned, which inevitably brings about relatively high costs.[63]

B. Non-coordinated effects

The previous chapter has shown the efficiency enhancing effects of vertical mergers. It has also drawn some conclusions about why firms choose to merge businesses. The reasons mainly revolve around cost saving effects of mergers that tip the balance in favor of merging previously independent firms. However, in its examination, the European Commission has to balance both pro-competitive effects of a merger with possibly anti-competitive effects.

Section II, para. 21 of the non-horizontal merger guidelines provide that:

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[62] Vertical and Conglomerate Merger Report, *supra* note 44, at 285.

[63] RBB Report, *supra* note 16, at 69.

> *"...The Commission examines the various chains of cause and effect with a view to ascertaining which of them is the most likely. The more immediate and direct the perceived anti-competitive effects of a merger, the more likely the Commission is to raise competition concerns. Likewise, the more immediate and direct the pro-competitive effects of a merger, the more likely the Commission is to find that they counteract any anti-competitive effects."*

Thus, there can be no doubt that the Commission has to evaluate both pro- and anti-competitive effects in its merger assessment. However, it is not entirely clear how such balancing is done in practice. This balancing depends on the chosen welfare standard in a society that determines how positive and negative effects are traded off against each other and whose interests are given more weight. There are some different definitions of "welfare standard," but the welfare standard basically consists of a balancing of consumer and producer surplus without considering other social objectives like whether a merger is likely to affect employment. In European merger policy, the so-called "consumer surplus (welfare) standard" is applied with the focus on the interests of consumers. However, not only is the likelihood of whether prices may rise after the merger considered, but there are also other factors taken into account, like the probability of increased product quality, service and innovation. This means that a merger can be cleared even if prices are expected to increase after the merger, because consumers may benefit from better product quality, services and innovation.[64] Such a weighing of pro- and anti-competitive effects must be applied in every individual merger case, as such effects are very merger-specific. Of course, such a trade-off is

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[64] An Renckens, *Welfare Standard, Substantive Tests, and Efficiency Considerations in Merger Policy: Defining the Efficiency Defense*, 3 J. COMP. L. & ECON. 2, 153-157 (2007) [hereinafter Renckens].

very difficult to assess, and the Commission must show that it will perform satisfactorily in future evaluations.[65]

After illustrating economic efficiencies in the previous chapter and providing the fundamental principles for balancing possible efficiencies with possible anti-competitive effects, one must take a a deeper look at the anti-competitive effects that result from vertical mergers, especially non-coordinated effects.

The most important non-coordinated effect that can occur after a vertical merger is foreclosure. Foreclosure results when access to supplies or markets for potential or actual rivals is denied or impeded due to the merger. Consequently, the concerned firms' competitiveness is reduced. For foreclosure, it is not necessary that the foreclosed firms are forced to leave the market completely. From the Commission's point of view, it is sufficient that the rivals are disadvantaged and consequently led to compete less effectively. Foreclosure is viewed as anti-competitive when the merging firms are able to profitably increase prices to the disadvantage of consumers.[66] "To increase prices" is a general term for various behaviors that result in competitive damage. If prices decrease less or are less likely to decrease than they would have been without the merger, and if prices increase more than they would have without the merger, then the Commission regards these results as anti-competitive due to the merger.[67] As mentioned in the introduction, there are two forms of foreclosure: input foreclosure and customer foreclosure.

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[65] Carles Esteva Mosso, *Non-horizontal Mergers: A European Perspective*, 31 FORDHAM INT'L L.J. 1442, 1482 (2008) [hereinafter Mosso].

[66] Non-Horizontal Merger Guidelines, *supra* note 5, pt. IV 29.

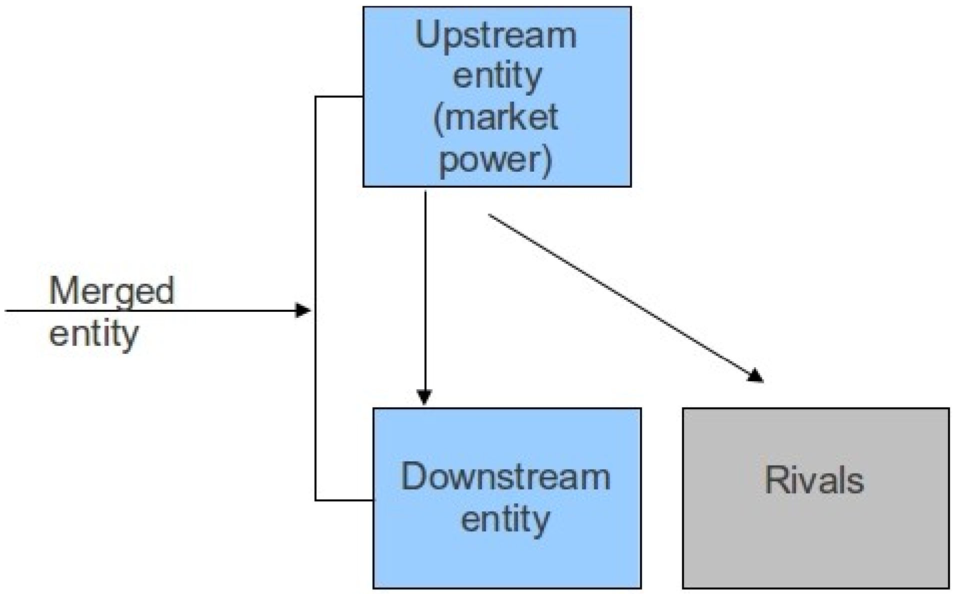
[67] *Id*. fn. 8.

1. Input foreclosure (three step assessment)

Input foreclosure occurs when a vertically integrated upstream firm forecloses downstream rivals by restricting or foreclosing access to inputs or by making access to inputs more expensive than would be the case without the merger.[68]

The term “input” is not only limited to goods, but can cover services, access to infrastructure, and access to intellectual property rights.[69]

The following diagram illustrates an input foreclosure scenario. In this diagram, there are two firms: an upstream firm with market power and a downstream firm. The upstream firm could be a manufacturer or a supplier to the downstream firms. Before the merger, the upstream firm sells products to both downstream firms, because it seeks to gain more profit. If the two firms, marked in blue in the diagram, merge, then only one vertically integrated entity exists (merged entity).



Raising rivals' cost?

[68] BELLAMY & CHILD , *supra* note 36, pt. 8.216.

[69] Non-Horizontal Merger Guidelines, *supra* note 5, fn. 24.

After the merger, the previously upstream firm becomes an indirect competitor of the downstream rival - marked in grey - because it merged with the downstream firm, a direct competitor. It is likely that, under certain circumstances, the upstream entity restricts access to supplies to the rival or makes it harder for the rival to get supplies. Because the upstream entity has market power, it may be difficult for the rival to switch to an alternative supplier, which could raise the rivals' cost for supplies.[70]

The Commission applies a three step assessment to examine possible anti-competitive effects of a proposed merger. First, it will test the merged entity's ability to substantially foreclose access to inputs. Second, it will evaluate whether the merged entity has the incentive to foreclose access to inputs. Finally the Commission examines whether the merger could lead to a significant detrimental effect on downstream competition.[71]

a) Ability to foreclose access to inputs

As described above, there are several forms in which input foreclosure can occur. For instance, potential competitors can be excluded from supply delivery, access can be restricted, or input can be supplied only at a higher price.

It is also a form of foreclosure when inputs are only supplied under unfair

conditions. A real-life example is a merger that occurred between firms in the telecommunication and satellite industry.[72]

The proposed merger raised serious competition concerns from the Commission, because the merged entity could delay delivery of important products for satellite components

[70] *Id*. pt. IV 31.
[71] *Id*. pt. IV 32.
[72] Opinion of the Advisory Committee on Concentrations Given at its 148th Meeting on 23 March 2007 Concerning a Draft Decision Relating to Case COMP/M.4403 - Thales/Finmeccanica/Alcatel Alenia Space/Telespazio, point 7, 2009 O.J. (C 34/4).

manufacturers. The upstream firm is active in producing satellite components, while the downstream entity needed this input in order to produce integrated systems for satellites. If the two entities merged, the Commission held the view that other downstream firms could suffer from delayed deliveries by the merged entity due to its market power. However, the Commission did finally clear the merger after an in-depth investigation was conducted and remedy packages were created for the firms involved.

It is also probable that a firm might select specific technology not compatible to its competitors' technologies as a result of the merger. The Axalto[73] case is a good example of this form of input foreclosure. In that case, one merging party was active in manufacturing secure plastic cards and related products and services, while the other party was active in supplying secure plastic cards, or so-called “smart cards.” If the merger was cleared, then a dominant position in the SIM-card market would have resulted. Consequently, in the merger investigation, several competitors stated that the parties would have the ability to undermine or degrade the activity of other card manufacturers by making the competitors' SIM-cards incompatible with mobile phone operators' OTA platforms. OTA, or “Over-The-Air,” platforms allow mobile phone operators to communicate with, download applications to, and manage a SIM-card without being physically connected to the card. OTA is technology that can update and change data in the SIM-card without needing to reissue it.[74] Furthermore, the parties to the merger would have control over acceptance of new cards, and could, therefore, leverage the supply of their own cards. In the end, the merging parties made some commitments that encouraged the Commission to drop the competition concerns, leading to the Commission’s clearance of the merger.

[73] Commission Decision on Case COMP/M.3998, Axxalto/Gemplus, (May 19, 2006) *available at* http://ec.europa.eu/competition/mergers/cases/decisions/m3998_20060519_20212_en.pdf.

[74] *Id*. at point 25.

Foreclosure can also occur through a worsening of the quality of an input supplied. For instance, this type of foreclosure would occur when a dominant upstream firm distinguishes supplies in terms of quality between its own downstream entity and other downstream competitors after a merger.[75]

A precondition for input foreclosure is that an important input needed for a downstream product must be involved. An indicator of this precondition is if the input represents a significant cost factor relative to the price of the downstream product.[76]

However, there are several other reasons why an input may be important, like when the input is a critical component needed for the downstream rivals' production process. For example, an engine starter would be a critical component without which the engine manufacturer could not profitably sell its product.[77]

To be considered input foreclosure, it is necessary that the merged entity has a substantial degree of market power in the upstream market, because only then is the merged entity able to dominate the other upstream firms in the above described manner, namely, the foreclosure scenario and influence on price and supply conditions. To be able to foreclose, it is necessary for the merged entity to be able to negatively affect the total availability of inputs for the downstream market. If this were the case, other downstream firms would be dependent on the merged entity's products. The upstream entity could influence the inputs in terms of price and quality, assuming there were too few competitive input suppliers or other input suppliers were unable to increase their output due to production processes, and the downstream competitors could not switch to alternative suppliers. Exclusive contracts between the merged entity and independent input suppliers could also be a source of increased

[75] Non-Horizontal Merger Guidelines, *supra* note 5, pt. IV 33.

[76] Commission Decision on Case COMP/M.4561, GE/Smiths Aerospace, point 48 (April 23, 2007) *available at* http://ec.europa.eu/competition/mergers/cases/decisions/m4561_20070423_20310_en.pdf.

[77] Case T-210/01, General Electric v. Comm’n, 2005 E.C.R. II-5575, point 298.

ability to foreclose access to inputs, because the independent suppliers would be bound to this contract.[78]

A merged entity may foreclose rivals' access to inputs, which can lead to a reduction of competitive pressure on other input suppliers. This can occur when the merged entity does not supply goods to downstream competitors, leading to increased demand for the upstream rivals' inputs. By increasing demand, they have more market power such that the upstream rivals face reduced competitive pressure and are able to increase prices. This outcome is only one of several that are possible, because foreclosing access to inputs or raising inputs' prices can also result in decreased demand for rivals' products such that they are forced to compete more aggressively in pricing policy. The Commission must examine all anti-competitive effects of a merger, which leads to the Commission evaluating possible counter-strategies of the merging parties' rivals. The competitors could, as an example, change their production processes in order to be less dependent on the merged entity's products.[79]

b) Incentive to foreclose access to inputs

A merged entity is only likely to foreclose access to inputs if foreclosing is profitable. The merged firm will not only consider the expected profits for the separate entities but will also evaluate the profit for the merged firm as a whole. For instance, when the upstream entity reduces its output to downstream competitors, it will assess how the expected profit losses upstream are balanced by increased demand downstream or by increased prices to consumers.[80]

[78] Non-Horizontal Merger Guidelines, *supra* note 5, pt. IV 35.
[79] *Id.* pt. IV 38-39.
[80] *Id.* pt. IV 40.

The Philips/Intermagnetics[81] case illustrates how this assessment is made in practice. In 2006 the Dutch company Koninklijke Philips Electronics N.V. ("Philips") wanted to merge with the US-based company Intermagnetics General Corporation ("Intermagnetics"). Philips is a company active in the fields of electronic products, domestic appliances, consumer electronics, semiconductors and medical systems, while Intermagnetics operates in the fields of magnets used in magnetic resonance imaging, medical devices like radio frequency coils and patient monitors, and several other fields of business. This proposed merger had a vertical relationship, because Philips produces and supplies magnetic resonance imaging ("MRI") systems to hospitals and universities, while Intermagnetics supplies some components of MRI systems like magnets and radio frequency coils ("RF-coils"). In this case, Intermagnetics was at the upstream level as Philips' input supplier, while Philips produced MRI-systems to sell to end consumers (downstream level). As input foreclosure concerns arose during the Commission's merger investigation, the two firms stated that input foreclosure would make no sense economically. The firms explained that they would not stop selling RF-coils to third party customers because of the high profit margins gained from RF-coils sales. They published a gross profit margin of 50-60 percent on sales of RF-coils, in contrast to only 5-10 percent on sales of MRI-systems.[82] In this specific case, Intermagnetics also had a contractual relationship with Siemens, which it would have to honor even if the merged entity foreclosed access to inputs to other rivals. Finally, the Commission found that any foreclosure would harm the profitability of the merged entity in the long run, and, therefore, it cleared the merger.

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[81] Commission Decision on Case COMP/M.4300, Philips/Intermagnetics (Nov. 7, 2006) *available at* http://ec.europa.eu/competition/mergers/cases/decisions/m4300_20061107_20310_en.pdf.

[82] *Id.* point 56 (Due to confidential information, no exact figures of gross profit margins are published in the Commission's merger decision).

This merger case shows that firms will accurately assess whether they plan to apply a foreclosure strategy to the disadvantage of their competitors or whether it is not attractive in terms of increasing the entity's profit. The firms will also take into account the changed margins downstream and upstream that may occur after a merger. Firms will normally only run a foreclosure strategy when they expect an adequate reward.[83] Another important point in the examination of a merged entity's incentive to foreclose inputs is the amount of downstream demand that it can seize from downstream competitors. This means that a merged firm will foreclose inputs to downstream rivals if it is able to stop consumers from buying competitors' products in favor of the merged entity's products. The more demand the merged firm is able to take from competitors, the higher the incentive there is to apply a foreclosure strategy.[84] On the other hand, if the input is not a critical component to the downstream product, then raising the input's cost would not have a serious effect on competition, as the GEES/Unison[85] case shows.

GEES (General Electric Engine Services Inc.) is a subsidiary of the General Electric group and produces aircraft engines. Unison Industries Inc. produces accessories for aircraft engines and power systems. GEES is a buyer, among other things, of ignition systems and alternators from Unison. In the field of aircraft engines, GEES holds a dominant position, but there were no vertical foreclosure effects to be feared from the merger. This is because Unison's products are of low technological value and are not the object of significant progress. This implies that there are no critical components without which GEES' competitors, namely, engine manufacturers, could not produce engines. The Commission decided that it would be relatively simple for engine manufacturers to source the needed

[83] Non-Horizontal Merger Guidelines, *supra* note 5, pt. IV fn 35.
[84] *Id.* part IV 42.
[85] Commission Decision on Case COMP/M.2738, GEES/Unison (April 17, 2002) *available at* http://ec.europa.eu/competition/mergers/cases/decisions/m2738_en.pdf.

products from other firms. As a result, a foreclosure strategy for the merged entity (GEES & Unison) would not likely be profitable due to relatively low switching costs for other firms to alternative suppliers.[86]

Whether raising rivals' costs by increasing input costs is profitable for the merged entity also depends on the downstream price level. If a dominant merged entity raises the input costs for competitors, the competitors' products are likely to be sold at higher prices due to the increased input costs. The price level will, consequently, rise and the merged entity itself can profit by marking up prices to a higher extent than before the merger. Nevertheless, this approach might only be profitable if there is a sufficiently large market share for the downstream entity. On the other hand, a high market share does not necessarily include the possibility of gaining high profits from consumers. It is possible that a monopolist has a "commitment problem" that it cannot solve. An example would be if a pre-merger downstream firm is ready to pay a high price to an upstream monopolist only if this monopolist commits to not sell extra quantities of goods to the downstream firm's competitors. However, once the terms of supply are determined, the upstream monopolist may want to expand sales to other downstream firms. Such a breach of contract is likely to be detected by the downstream firm, which would make the purchase unprofitable. If the upstream monopolist and the downstream firm were merged, then the upstream entity would have to consider the downstream entity's profits and could not expand its sales to other competitors. In this case, the firm cannot leverage its high market share. Due to the fact that the firm cannot extract all profits from the market, the entity could have an incentive to raise its rivals' costs. This approach implies that it could lower the competitive pressure exerted by its competitors, as it would then be more difficult to undercut the dominant entity's prices.[87]

[86] *See Id.* point 19.
[87] Non-Horizontal Merger Guidelines, *supra* note 5, pt. IV 43-44.

Besides, the Commission takes several other factors into consideration when evaluating foreclosure incentives. Ownership structure of the merged entity could be such a factor. The company, or companies, that controls a merged entity gives some useful information on whether it will apply a foreclosure strategy. This means that it makes a difference if two firms control an upstream firm (joint control), where: only one firm is also active in the downstream market, or 2) both firms are active in the downstream market. The firm that is not active in the downstream market may, under normal circumstances, have no interest in waiving input sales, which results in no increased risk of foreclosure.[88]

The Commission also attaches importance to the fact that, in a similar situation in the past, a competitor with a similar market share to the merged entity foreclosed access to inputs to competitors. In a merger investigation conducted in 2003,[89] a competitor of one merging party showed that it may be commercially rational to stop licensing, namely, input foreclosure with no access to technology. In this prior case, Alcoa, the firm with which the Commission drew a comparison, had the second best technology and a similar market share in primary aluminium, and it stopped licensing in the 1980s. The Commission considered it indicative a comparable competitor applied a foreclosure strategy in the past; as a result, they thought it likely that an application of a similar foreclosure strategy might occur in the case at hand.[90]

Such a consideration is highly complex because the Commission has to assess whether such behavior will or will not be applied. The fact that in the past, under similar conditions, other competitors applied a foreclosure strategy should only be an indicator that leads to a more in depth investigation by the Commission. The Commission then must evaluate both the incentives to foreclose and, on the other hand, those factors that reduce or eliminate the

[88] *Id.* pt. IV 45.
[89] Commission Decision on Case COMP/M.3225, Alcan/Pechiney (Sep. 29, 2003) *available at* http://ec.europa.eu/competition/mergers/cases/decisions/m3225_en.pdf.
[90] *Id.* point 40; Non-Horizontal Merger Guidelines, *supra* note 5, pt. IV fn 42.

incentives to foreclose. However, the ECJ[91] in the Commission versus Tetra Laval[92] verdict held that it would run counter to the Regulation's purpose of prevention to require the Commission to comprehensively examine the extent to which the incentives to adopt unlawful conduct would be reduced or eliminated in every merger case. In particular, it is, therefore, not necessary for the Commission to examine the legal provisions of several legal orders that might be applicable in terms of prohibiting such unlawful conduct.[93]

c) Overall likely impact on effective competition

As provided in Art 2 (2) ECMR, a concentration should be declared compatible with the common market if it would not significantly impede effective competition in the common market or in a substantial part of it. When the new EC Merger Regulation replaced the original Merger Regulation[94] in 2004, a new test was introduced to evaluate whether a concentration impedes competition. The so-called SIEC-test, or "Significant Impediment to Effective Competition" test, replaced the "dominance"-test used in the original Merger Regulation. This occurred because a creation or strengthening of dominance was a necessary prerequisite, in terms of impact, on competition under the original Merger Regulation. However, it is insufficient to focus only on the creation of a dominant position, as there are circumstances when a dominant position is created only temporarily, and, thus, is not likely to significantly impede effective competition. So, under the current EC Merger Regulation, a formal finding of dominance is no longer required; instead, a broader review is applied than to only review whether there has been creation or strengthening of dominance.[95]

91 With the enactment of the Treaty of Lisbon, the European Court of First Instance was renamed the "General Court."
92 Case C-12/03, Comm'n v. Tetra Laval BV, 2005 E.C.R. I-987, 75.
93 For more case law, see Non-Horizontal Merger Guidelines, *supra* note 5, pt. IV 46.
94 Merger Regulation 4064/89, 1989 O.J. (L 395) 1 (EC).
95 BELLAMY & CHILD, *supra* note 36, pt. 8.197.

It is crucial, when evaluating mergers, to question whether effective competition is significantly impeded. For such an impediment to take place, it is normally required that the foreclosed rivals play an important role in the downstream market. A merger is more likely to disturb effective competition when more rivals are affected by foreclosure, because it is likely that prices will increase in the downstream market after a merger leads to input foreclosure. On the other hand, it is not impossible that a firm can play a significant role in competition even with a relatively small market share compared to other competitors.

This can be the case when a firm is a close competitor of the merged entity, or when it is an aggressive competitor, a so-called "Maverick."[96] If barriers to entry for potential competitors are raised, then this phenomenon may also lead to a substantial impediment to effective competition. Such a concern was raised by the notifying parties' competitors[97] in a case in the waste incineration industry. The competitors feared that they could be foreclosed by the prospective merged entity and that barriers to entry could be introduced as a result of increased incineration prices. Such increased prices would then raise barriers in the collection market, because competing collectors would have difficulties in gaining access to incineration. What is more, even if existing competitors gained access to incineration facilities, the notifying competitors argued that market entrants would still not be competitive compared to the merged entity due to high prices for incineration.

Even a significant likelihood that a merged entity will apply a foreclosure strategy can be sufficient to raise barriers to entry for potential competitors, as firms always include such risks in evaluating whether it is prudent to enter a market. If private companies plan to enter a market that requires large investments, then companies evaluate all relevant risks, because

96 Non-Horizontal Merger Guidelines, *supra* note 5, pt. IV 48.
97 Commission Decision on Case COMP/M.4576, AVR/Van Gansewinkel, point 33 (April 3, 2007) *available at* http://ec.europa.eu/competition/mergers/cases/decisions/m4576_20070403_20310_en.pdf.

they ultimately strive for a good return on investment with as few risks as possible. When such a potential market entrant foresees a foreclosure strategy from a prospective merged entity, it has to budget this strategy into its risk evaluation in order to decide whether to enter a market. Such a foreclosure strategy can have an especially strong deterrent effect in industries that require large investments, like the power plant industry. Indeed, these were relevant considerations in the E.ON/MOL[98] case, where concerns were raised that E.ON would, after a merger, be both the unique significant gas supplier and also active in the electricity market. Such a circumstance might then have a deterrent effect by increasing the risk-level of a project for competitors.

Barriers to entry can also be raised when potential competitors are forced to enter both the upstream and the downstream market by vertical integration. Such a need for potential competitors to enter both markets to succeed is especially important in those markets that are being liberalized and are opening for the first time where monopoly previously existed.[99] In today's world, where state control in many sectors is not desired, markets have to be opened for competition. Previously, people were dissatisfied with the performance of monopolists due to a lack of competition, which ultimate led to the belief that a state should reduce its monopolies.[100] Due to the dominant position and market power of such a monopolistic entity, competitors are likely to be deterred from entering the market. If firms have to enter both markets upstream and downstream in order to compete effectively, then such entry results in significant costs and large investments. In such industries where former national monopolies

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98 Commission Decision on Case COMP/M.3696, E.ON/MOL, point 663 (Dec. 21, 2005*) available at* http://ec.europa.eu/competition/mergers/cases/decisions/m3696_20051221_20600_en.pdf.

99 Non-Horizontal Merger Guidelines, *supra* note 5, pt. IV 49.

100 MONTI, *supra* note 8, at 441.

existed and are being opened to competition, it is crucial to regulate liberalization measures on an EU basis rather than to leave such regulation to the respective national states.[101]

On the other hand, effective competition is not impeded when a sufficient number of downstream competitors are left over after a merger and their costs are not raised as a result of the merger. It is possible that costs will not be raised when the competitors are themselves vertically integrated or are able to switch input suppliers, such that they can get input from an alternative and more cost-effective source. In these circumstances, competition may not be impeded, because competition from the merged entity's rivals may establish a strong constraint on the merged entity, which likely means that prices will not increase after the merger takes place.[102] In the merger between Siemens and VA Tech,[103] for example, the Commission concluded that the last independent credible supplier for electrical traction for regional trains would be eliminated as a result of the merger (takeover of ETR, a VA Tech subsidiary by Siemens). However, the fact that a credible independent supplier in the market for tram and underground tram traction as well as for electrical tram traction would still exist post-merger, meaning that sufficient competition for downstream rail vehicles would remain, led the Commission to ultimately clear the merger.

Countervailing factors, like the presence of countervailing buying power, must also be examined to determine whether a merger will substantially impede effective competition. The Commission, in its non-horizontal merger guidelines, refers to the specific chapter in its horizontal merger guidelines[104] for this assessment. Countervailing buying power means that competitive pressure does not have to strictly come from competitors but can also come from

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[101] BELLAMY & CHILD, *supra* note 36, pt.12.002.
[102] Non-Horizontal Merger Guidelines, *supra* note 5, pt. IV 50.
[103] Commission Decision on Case COMP/M.3653, Siemens/VA Tech, point 164 (July 13, 2005) *available at* http://ec.europa.eu/competition/mergers/cases/decisions/m3653_20050713_20600_en.pdf.
[104] Horizontal Merger Guidelines, *supra* note 2, § V.

the merged entity's customers. Given a merged entity with high market share, it is not necessarily true that it can impede effective competition due to the fact that its customers may possess significant buying power through their size, commercial significance, or ability to switch to alternative suppliers.[105]

For instance, a buyer could exercise its countervailing buying power by persuading potential entrants to enter the market when the merged entity tries to exercise its market power. The following case demonstrates this phenomenon.[106]

Two firms, Enso and Stora, were active in the same upstream market producing liquid packaging boards. These two firms wanted to horizontally merge businesses. The liquid packaging board market consists of only a few large producers and a few large buyers. In Europe, only two other firms besides Enso and Stora were active as producers of liquid packaging boards. However, Enso and Stora were the two largest players in the production market. Likewise, there was only one large buyer of liquid packaging boards, Tetra Pak, who had a market share between 60 and 80 percent[107]. Besides Tetra Pak, only two smaller firms were active in the buyer market. After the merger between Enso and Stora, the supply market would consist of one large supplier (Enso/Stora's merged entity) and two smaller suppliers, while the buyer market would consist of one large buyer (Tetra Pak) and two smaller buyers. In this case, the buyer market was so dominant that the post-merger Enso/Stora entity could not afford to increase prices due to the considerable amount of countervailing buying power. Tetra Pak bought more than 50 percent of its inputs from Enso and Stora, which totalled more than 250,000 tons per year. Under these circumstances, where Tetra Pak had such high buying power, the merged entity might lose its best customer by increasing prices. Tetra Pak could

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105 BELLAMY & CHILD, *supra* note 36, pt. 8.227.
106 Commission Decision on Case COMP/M.1225, Enso/Stora, 1999 O.J. (L 254) 9 [hereinafter Enso/Stora].
107 The exact market share has not been published due to confidential business information.

also encourage other firms to enter the upstream production market if it promised to buy large amounts of their goods. The Commission found that Tetra Pak had such a countervailing buying power that it could offset the increased market power of Stora and Enso after their merger. Thus, the merger was declared compatible with the common market. Though this case was decided under the original merger regulation and though it concerned a horizontal merger, the same applies for non-horizontal mergers with respect to buying power.[108]

As this case has shown, it is more likely that only large and experienced customers will have such a countervailing buying power rather than smaller firms in a fragmented industry. Another way in which a buyer could exercise buying power is by refusing to buy other goods from the merged entity.[109]

Besides assessing the likelihood of countervailing buying power, the Commission also has to examine the likelihood of entry to markets. A merger is unlikely to raise competition concerns if market entry is so easy that it is sufficiently possible for potential rivals to enter the market. The Commission has to evaluate whether potential entry is likely and whether it is appropriate to constrain the behavior of the incumbents post-merger. The likelihood of entry is high when the financial risk of failing to enter the market is low, and entry would be economically profitable for potential firms. On the other hand, entry is unlikely when the dominant merged entity can protect itself by giving those firms special conditions that a new entrant tries to acquire or by providing long-term contracts to customers. Indeed, there is always a trade-off for new entrants between entry risks and entry costs. If barriers for entry are high, then the likelihood of entry is low due to the high costs expected from coming into

[108] Enso/Stora, *supra* note 106, at 9 (see pts. 84 – 92).
[109] Horizontal Merger Guidelines, *supra* note 2, § V 65.

the market. In addition, the merging firm would not suffer from increased competition from new entrants but could raise prices instead.[110]

There are several conceivable barriers to entry. For instance, there could be legal advantages that limit the number of market participants, such as a limited number of licenses issued per year as is the case in the telecommunication sector. Another example is that incumbents could benefit from technical advantages, like preferential access to important facilities, natural resources, innovation and research and development (R&D). Furthermore, in many industries it is essential to have reputation and sufficient know-how in order to successfully enter the market. In addition, the Commission takes the development of the concerned market into account. When a market is expected to shrink, the incentive for a potential entrant may be marginal. Conversely, markets that are expected to grow rapidly exert a strong incentive for firms to enter, which then limits the incumbent's incentive to raise prices.[111]

In its merger examination, the Commission also has to take efficiencies into consideration that will be generated through the merger. As merger-specific efficiencies are dealt with in detail in chapter V./A. of this thesis, further discussion is reserved for that chapter. Briefly put, efficiencies are cumulatively required to benefit consumers, be merger-specific, and be verifiable. These requirements have been drawn up by the Commission in accordance with Community jurisprudence.[112] The fact that efficiencies have to be merger-specific implies that these efficiencies must be a direct consequence of the merger and that these efficiencies cannot be achieved to the same extent through less anti-competitive

[110] Id. § V 68–70.
[111] Id. § V 71.
[112] Non-Horizontal Merger Guidelines, *supra* note 5, pt. IV 53.

alternatives. Verifiability means that efficiencies have to be reviewable by the Commission as the competent competition authority.[113]

d) Case studies

This chapter deals with case studies regarding vertical mergers that were accepted or prohibited by the European Commission. Taking a look at the European Merger statistics,[114] the proportion of clearance decisions[115] to prohibition decisions gives some insight into the European competition policy. In the period from September 1990 to August 2010, more than 5760 transactions were cleared and, hence, declared compatible with the common market. On the other hand, only 20 mergers were prohibited. Some of these decisions to declare mergers incompatible with the common market have since been annulled by the Court of First Instance. Importantly, all types of mergers were included in these statistics such that there is no distinguishment between horizontal and non-horizontal mergers.

With respect to prohibition decisions for vertical mergers, the most prominent cases took place in the media sector.[116]

One example of a pure prohibition decision was the proposed merger by MSG Media Services in 1994.[117] In this case, Bertelsmann AG ("Bertelsmann"), Deutsche Bundespost Telekom ("Telekom") and Taurus Beteiligungs AG ("Taurus") all wanted to set up a joint venture under the name MSG Media Service.

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113 Renckens, *supra* note 64, at 168.
114 *Available at* http://ec.europa.eu/comm/competition/mergers/statistics.pdf.
115 Including transactions declared compatible with commitments.
116 Johannes Gruber, *Konglomerate Zusammenschlüsse*, RECHT DER WIRTSCHAFT 511, 553 (2006) [hereinafter Gruber].
117 Commission Decision on Case COMP/M.469, MSG Media Services, 1994 O.J. (L 364).

Bertelsmann was the common parent company of the leading German media group. It was active in book and magazine publishing, book clubs, printing, music publishing and sound recording. It also had holdings in commercial television.

Taurus belonged to the Kirch group, which was the leading German supplier of feature films and television programming and was also active in commercial television.

Telekom was active in all areas of telecommunications services, as it was the public telecommunication operator in Germany. It had a monopoly in the German telephone network and was the owner and operator of nearly all German cable-television networks.[118]

The three parties wanted to set up a joint venture named MSG Media Services whose purpose would be to handle the technical, business and administrative aspects of payment-financed television and other services, such as conditional access and subscriber customer management. In addition, the entity would provide the technical infrastructure for the supply of these services.[119] In its examination, the Commission reviewed: 1) both the relevant product and the geographic markets for technical and administrative services in Germany, 2) the pay-TV market in Germany, and 3) the cable network market in Germany. The Commission found that MSG Media Services would hold a durable, dominant position in all investigated markets after the merger. The Commission explained that the market for technical and administrative services at that time only had one competitor: Premiere, which was jointly controlled by Bertelsmann, Kirch and Canal Plus. Premiere was the only supplier of pay-TV, while, at the same time, Telekom was the monopolist in the cable network operator market. Without the merger, both firms would need to install their own infrastructure for digital pay-TV. However, with the merger, only one infrastructure would be necessary, which would have strengthened the firms’ dominant position.

118 Id. § I.
119 Id. § II.

Another concern was input foreclosure. If a pay-TV program supplier wanted to join the market, it would have needed access to the merged entity's technical and administrative infrastructure. However, if the merger was cleared, then the joint venture MSG would have had such a dominant position that it could foreclose access to their infrastructure for other pay-TV suppliers.

The merger was finally prohibited for these reasons. Importantly, this merger survey was conducted under the original merger regulation, where the dominance test, as described above, was prevailing. There were some other mergers that the Commission blocked due to foreclosure concerns, especially in the media market.[120] However, this stringent merger policy has been softened over the years. Currently, the Commission tries to clear mergers subject to conditions that should remove such competition concerns as foreclosure.[121]

A good example of this new Commission merger policy is the merger between SFR and Télé 2 France,[122] because it is also a merger in the media sector with concerns of foreclosure effects. The concerns were put to rest due to commitments made by each party. This merger is quite up-to-date, as it was decided in 2007 under the new merger regulation.

On November 28, 2006, the Commission received notice from the parties of a proposed concentration in which SFR would acquire sole control of the internet access and fixed telephone business of Télé 2 France through share purchases. After the Commission received the notification from SFR and Télé 2 France, it stated that the proposed acquisition raised serious competition concerns; consequently, the Commission launched an in-depth

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[120] *See* Commission Decision on Case COMP/M.490, Nordic Satellite Distribution, 1996 O.J. (L 53) 20; Commission Decision on Case COMP/M.993, Bertelsmann/Kirch/Premiere, 1999 O.J. (L 53) 1; *see also* Gruber, *supra* note 117, at 553 fn. 18.

[121] MONTI, *supra* note 8, at 270.

[122] Commission Decision on Case COMP/M. 4504, SFR/Télé 2 France (July 18, 2007) [hereinafter SFR/Télé 2 France], *available at* http://ec.europa.eu/competition/mergers/cases/decisions/m4504_20070718_20600_en.pdf.

investigation. During this investigation, the two companies made proposals for commitments in order to make the concentration compatible with the common market.[123]

SFR is a public limited-liability company that is active in the mobile telephone sector. SFR is jointly controlled by Vivendi and Vodafone. Vivendi is a French conglomerate active in the media and telecommunications sectors, while Vodafone is a British telecommunications company. The Vivendi group's main business areas are pay-TV (via the Canal+ group), cinema, music, interactive games and the telecommunications sector.

Télé 2 is engaged in the fixed telephony and Internet access provision sector as well as the pay-TV sector. The proposed merger's impact would concern the pay-TV sector in France.[124] The Commission investigated the product market for pay-TV in France and demonstrated that the producers of the channels decide on the themes and programming strategy of their channels at the intermediate level of the market. They either produce their own programs in-house or buy broadcasting rights for the programs that they want to show, such as films, series, and sports events. Third parties then buy this content on upstream markets. The producers also sell the rights to market their channels to downstream distributors. The distributors then sell these channels to consumers by offering subscription-based or pay-per-view TV channel packages. The distributor promotes the channels by advertising or direct marketing of the channel packages. The distributor also sells or rents reception equipment and terminals to subscribers, and it provides decryption of the received programs. The delivery methods in France are cable, satellite, DSL and terrestrial, namely, analogue and digital.[125]

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[123] *Id*. point I.
[124] Press Release, European Commission, Mergers: Commission Authorises Acquisition of Télé 2 France by SFR Subject to Conditions, (July 18, 2007) [hereinafter SFR Acquisition Press Release].
[125] SFR/Télé 2 France, *supra* note 122, § VI.

In its market survey, the Commission found that the downstream DSL distribution market for pay-TV is the fastest growing in the pay-TV distribution market. It further stated that DSL operators are the main competitors capable of putting pressure on the French pay-TV market. Before the merger, however, DSL operators already had the problem that they could not sufficiently compete against the Vivendi group, because they did not have sufficient access to Vivendi's television programs and channels.[126]

The Commission examined both horizontal and vertical effects of the proposed merger. With regard to vertical effects, it discovered that Vivendi might have a strong incentive to foreclose downstream rivals' access to channels and broadcasting rights (input foreclosure). As post-merger Télé 2, the downstream distributor, belonged to SFR and, therefore, to the Vivendi group (the upstream firm), the Vivendi group would favor SFR/Télé 2 in terms of access to content and would most likely foreclose independent DSL operators. In its conclusion on the competition analysis, the Commission stated that the proposed merger was likely to significantly weaken the competitive pressure exercised by the DSL operators on all pay-TV markets in France. The merger would lead to both higher prices for pay-TV and lower quality of the programs offered and, therefore, should be declared incompatible with the common market, or a substantial part of it, in accordance with the EC Merger Regulation.[127]

Vivendi and SFR were given the opportunity to submit commitment proposals in order to guarantee that downstream competitors would not be discriminated against after the merger. These commitments from Vivendi and SFR concerned three issues. First, Vivendi committed to allowing all DSL operators to distribute all channels to which SFR/Télé 2 is given access on normal market terms, which would lead to no comparable discrimination. Second, with respect to the channel packages distributed by Vivendi through DSL networks,

[126] *Id*. point 70.
[127] *Id*. point 102.

Vivendi made the commitment that it would not prefer SFR/Télé 2 subscribers to subscribers from other competitors. Third, SFR/Télé 2 would be excluded from buying exclusive DSL distribution rights to channels produced by third parties for which Vivendi does not obtain such rights. The last point of the commitment concerned “Video on Demand.” Vivendi and SFR committed to not purchase exclusive “Video on Demand” rights to the latest American and French films.[128]

After these commitments were made, the Commission no longer had competition concerns and cleared the merger under Article 8 (2) ECMR.

This example shows the changed competition policy from earlier complete prohibition policy to the current policy of clearance subject to conditions. It is also worth considering that in most cases, whether it is a horizontal or non-horizontal merger, there are mostly horizontal and non-horizontal effects to evaluate. A vertical merger is likely to have horizontal competitive effects, and on the other hand, a horizontal merger may have strong vertical effects, as was the case in the above described merger. The same applies to conglomerate and vertical effects.[129]

2. Customer foreclosure

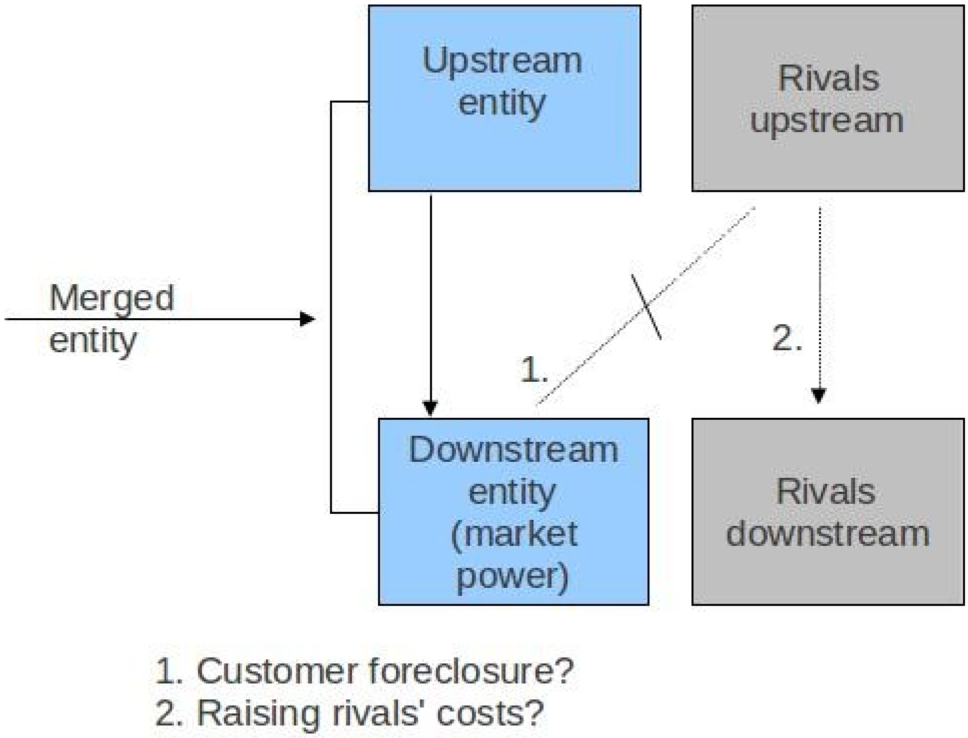
Contrary to input foreclosure, where an integrated firm forecloses other downstream firms, customer foreclosure may result when an upstream supplier integrates with an important customer in the downstream market. Customer foreclosure occurs when the downstream entity forecloses access to a sufficient customer base to its actual or potential

[128] *See* SFR Acquisition Press Release, *supra* note 124.
[129] *See* Commission Decision on Case COMP/M.2416, Tetra Laval/Sidel (Oct. 30, 2001) *available at* http://ec.europa.eu/competition/mergers/cases/decisions/m2416_en.pdf (presents example of having both vertical and conglomerate effects examined).

rivals in the upstream market, which, consequently, reduces their ability or incentive to compete in the market. Such customer foreclosure may lead to increased costs for rivals, because downstream competitors have more difficulty obtaining input supplies under similar prices and conditions, as was the case before the merger. Under these circumstances, where it is harder for downstream rivals to get adequate access to supplies, the merged entity can profitably bump up prices on the downstream market. As described above in the chapter about efficiency-enhancing effects, the Commission has to take pro-competitive effects into consideration, which may result in lower prices to the benefit of consumers, when evaluating a merger. Thus, the necessary consideration for customer foreclosure is not that consumer harm results from the forced exit of the merged entity's rival; instead, it is relevant whether such a foreclosure strategy will lead to higher prices for consumers.[130]

The difference between customer foreclosure and input foreclosure is that input foreclosure comes from the dominant upstream firm, while customer foreclosure comes from the dominant downstream entity foreclosing an upstream rival. A diagram – on the next page – illustrates customer foreclosure.

[130] Non-Horizontal Merger Guidelines, *supra* note 5, pt. IV 58.



This illustration[131] shows a customer foreclosure scenario. Before the merger, the downstream entity, which is now the one with market power compared to the input foreclosure scenario in which the upstream firm has market power, would most likely buy from upstream rivals, marked in grey, due to normal competition. After the merger, customer foreclosure can result if the downstream entity refuses to buy from upstream rivals.

The Commission applies the same three step approach in merger control examination as it applies in input foreclosure. First, the Commission examines whether the merged entity would have the ability to foreclose access to downstream markets by reducing or stopping purchases from upstream rivals. Second, the Commission examines whether the merged entity would have the incentive to adopt customer foreclosure. Lastly, the Commission examines

[131] *Compare* Non-Horizontal Merger Guidelines, *supra* note 5, pt. IV fig.2.

whether such a foreclosure strategy would have a significant detrimental effect on competition in the downstream market.[132]

a) Ability to foreclose access to downstream markets

The merged entity affects upstream rivals when their costs for access to downstream customers increase or they face restricted access to a major customer base. This may occur when the downstream entity sources all required inputs from the merging upstream entity and, as a result, other upstream competitors are excluded from selling goods to the downstream entity. Instead of stopping or reducing purchases from upstream competitors, the downstream entity could purchase on worse terms and conditions from upstream rivals than before the merger.[133]

In its assessment of the ability for a merged entity to foreclose access to upstream rivals, the Commission investigates whether there are enough alternative purchasers to which an upstream rival could sell its goods. This means that the merged entity must contain a firm that is important in the downstream market due to substantial market power.[134] A good example of such a dominant firm in the downstream market is the Enso/Stora[135] case, described above, which illustrates the effect of countervailing buying power. Tetra Pak was such an important customer in the downstream market that would easily have had the power to stop purchasing from upstream rivals if Tetra Pak were vertically integrated. However, if there is a sufficient customer base such that a customer foreclosure strategy is unlikely to be

[132] Non-Horizontal Merger Guidelines, *supra* note 5, pt. IV 59; *see also* Commission Decision on Case COMP/M. 4389, WLR/BST, point 31 (Dec. 5, 2006) [hereinafter WLR/BST], *available at* http://ec.europa.eu/competition/mergers/cases/decisions/m4389_20061205_20310_en.pdf.
[133] Non-Horizontal Merger Guidelines, *supra* note 5, pt. IV 60.
[134] *Id*. pt. IV 61.
[135] Enso/Stora, *supra* note 106, at 9 .

implemented, then competition would not be significantly impeded.[136] There is not only a risk that a customer foreclosure strategy could increase input prices, but it could also present a risk of heightened barriers to entry for prospective entrants. This is likely to happen when the downstream entity with market power stops or reduces purchases from upstream competitors, which will lead any prospective profits to shrink. This may have the effect of deterring potential entrants, resulting in the customer foreclosure strategy having a negative impact on competition. If the merged entity is able to set up entry barriers to the market, then input prices will likely stabilize at a higher level for other downstream firms than if the merger had not taken place.[137]

Such higher input costs that result from a vertical merger may have the potential to radically reduce upstream competitors' incentive to improve product quality, invest in R&D, or invest in cost reduction due to the decreased profits. Such reduced investment incentives and weakened competition may ultimately lead to market exits. In addition, it is possible for a customer foreclosure strategy to be carried out in only one of several markets but to still have negative effects on other markets. For instance, an upstream rival, when faced with higher input costs for one market, may be forced to price highly in every market in which it is active. This may occur when a considerable part of the downstream market is foreclosed, making the upstream competitor unable to operate at low costs in other markets; rather, it has to operate at higher costs in all markets where it is active, because it is not able to offset incurred losses from a substantial part of one market with profits from other markets. On the other hand, it may be possible for an upstream rival to find alternative uses for goods, making the loss from higher input costs tolerable.[138]

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[136] WLR/BST, *supra* note 132, pt. 31.
[137] Non-Horizontal Merger Guidelines, *supra* note 5, pt. IV 64.
[138] *Id*. pt. IV 65-66.

With regard to merger assessments by the Commission, the Commission will also consider possible timely counter-strategies carried out with respect to the input foreclosure. Such counter-strategies by upstream rivals may include the possibility that rivals will price more aggressively in order to sustain the pre-merger sales levels, which would result in less customer foreclosure.[139]

b) Incentive to foreclose access to downstream markets

According to the Commission's non-horizontal merger guidelines, the merged entity will face a trade-off between possible costs associated with not sourcing goods from upstream rivals and possible gains from doing so in order to evaluate its incentive to apply a customer foreclosure strategy.[140]

However, these remarks were criticized during the public consultation process on the drafts of the non-horizontal merger guidelines. The Federation of German Industries and the German Chambers of Industry and Commerce stated in their paper,[141] that such balancing procedures are highly complex due to the comparison of several factors that have to be considered by firms. Such factors include profit margins and market shares in the relevant markets and the impact of consumers' and competitors' reactions to the firms' alternative strategies. The authors pointed out that such a trade-off can be performed only in exceptional circumstances. This is the case since, in practice, information for such a trade-off is not perfect. The Commission would act on the assumption of a theoretically perfect model of

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[139] *Id*. pt. IV 67.

[140] *Id*. pt. IV 68.

[141] Alexander Lau & Hildegard Reppelmund, *Entwurf der EU-Kommission von Leitlinien zur Bewertung nicht-horizontaler Fusionen nach der Verordnung (EG) Nr. 139/2004 des Rates vom 20. Januar 2004 über die Kontrolle von Unternehmenszusammenschlüssen*, BUNDESVERBAND DER DEUTSCHEN INDUSTRIE E. V./DEUTSCHER INDUSTRIE UND HANDELSKAMMERTAG (2007) *available at* http://ec.europa.eu/comm/competition/mergers/legislation/non_horizontal_consultation.html.

information. Normally, even business leaders would not get all the relevant information necessary to render such a consideration. Furthermore, conglomerate companies consist of many business units, each of which with a separate profit center. This implies that no business unit will waive its own profit simply for the uncertain hope that another business unit will make up for that lost profit. Having said this, managers usually get paid for the performance of their business units and not for the profits of other units, and, therefore, it is likely that they will not agree to such a strategy.[142]

Nevertheless, the Commission still chooses this method to evaluate incentives to foreclose access to downstream markets, because the firms themselves employ a balancing strategy to decide whether to render such a foreclosure strategy or whether it is not profitable. According to the Commission, firms may consider that reducing purchases from upstream competitors will lead to higher costs for the merged entity if the upstream entity of the integrated firm works less efficiently than the foreclosed upstream firms. The same applies to upstream entities that are capacity constrained or when competitors' products are more valuable in terms of product differentiation, rendering a foreclosure strategy unprofitable. However, a vertically integrated company still evaluates whether a foreclosure strategy would lead to the possibility of increased profits from raising prices in the upstream market. The incentive to perform such a foreclosure strategy becomes all the more attractive when the downstream entity of the merged firm enjoys benefits from the increased price level.[143]

[142] *Id.* pt. 5.
[143] Non-Horizontal Merger Guidelines, *supra* note 5, pt. IV 69-70.

c) Overall likely impact on effective competition

In its final step of the three step approach in merger control, the Commission examines whether foreclosing rivals in the upstream market will have negative effects in the downstream market and will subsequently lead to consumer harm. During this assessment, the Commission balances the negative impacts on effective competition with merger-specific efficiency gains.[144]

There may be a problem for upstream rivals of the merged firm if they are precluded from access to an important customer base and, therefore, are not able to sell their products. This will reduce their competitiveness in the long run. The fact that the merged entity operates in the downstream market as well as in the upstream market results in the likelihood for downstream competitors to be at a competitive disadvantage. They have to source their goods from upstream firms that may not be as competitive as the upstream entity of the merged firm, and, therefore, they have to pay a higher price for the required inputs. Thus, the merged entity is able to increase prices or, conversely, to reduce output in the downstream market, which would have the same effect due to fewer choices. Contrary to the evaluation of competition for input foreclosure, where a strategy to raise prices is directly and immediately perceptible by downstream rivals, such clarity is usually not available for a customer foreclosure strategy. If a merged downstream entity forecloses access to its customer base for upstream rivals, then this behavior will lead to increased costs for those upstream firms. Upstream firms, then, will either have to increase prices for customers or accept lower profit margins. Consequently, considerable time may be necessary for such negative effects to be passed on to consumers.[145]

[144] Thomas Weck & André Scheidtmann, *Non-horizontal Mergers in the Common Market: Assessment Under the Competition Commission's Guidelines and Beyond*, 29 EUR. COMP. L. REV. 8, 484 (2008).
[145] Non-Horizontal Merger Guidelines, *supra* note 5, pt. IV 72-73.

A customer foreclosure strategy is only capable of significantly impeding effective competition in the upstream market when a large share of the output is affected. More specifically, a merger that will likely lead to foreclosure of an upstream rival to the downstream entity's customer base will only impede effective competition when such an output is quite large. On the contrary, if there are a significant number of other upstream rivals not affected by customer foreclosure, then the risk for increased prices on the downstream market is negligible and, consequently, consumers will not be harmed. In other words, competition in the upstream market must be strong enough that competition concerns will not arise when one or more upstream rivals are affected by foreclosure. As with the examination of input foreclosure, customer foreclosure concerns are only eliminated when those upstream firms not affected by foreclosure are also not confronted with barriers to expansion. As explained in the section on input foreclosure, raising barriers implies that potential competitors would need to enter both upstream and downstream markets in order to compete efficiently.[146]

Again, the Commission has to apply the same criteria in light of efficiencies with customer foreclosure as it does with the examination of input foreclosure. This is because efficiencies may lead the merged entity to reduce prices such that no overall negative impact on consumers is expected, which is in line with the EU’s overarching competition goal of maximizing consumer welfare.[147]

[146] *Id*. pt. IV 74-75.
[147] Mosso, *supra* note 65, at 1442, 1466.

d) Case studies

This paper will now discuss a prominent vertical merger case[148] in the energy sector that was prohibited. In 2004, the European Commission decided to prohibit the proposed acquisition of joint control over Gás de Portugal (GDP), the incumbent gas company in Portugal, by Energias de Portugal (EDP), the incumbent electricity company in Portugal and ENI, an Italian energy company.[149]

To better understand this case, it is essential to briefly review the structure of European energy markets. Thirteen years ago, in 1998, the Commission started to implement a liberalization process in European energy markets. The goal was to increase competition in order to bring energy price levels to competitive levels for the benefit of consumers. There were several key issues on which the Commission focused, including: 1) the separation of operators, networks and other essential infrastructure from energy producers and suppliers, and 2) non-discriminatory access to networks for third parties. However, the Commission was confronted with the fact that despite liberalization, the European energy markets remained largely national and dominated by domestic suppliers. At the beginning of the liberalization process, only industrial energy consumers were free to switch to alternative energy suppliers. However, the Commission was not satisfied with the approach the Member States took to introduce competition in their states, because this was done in an inefficient manner such that the position of incumbent companies could not realistically be changed.[150]

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148 Commission Decision on Case COMP/M.3440, ENI/EDP/GDP (Dec. 9, 2004) [hereinafter ENI/EDP/GDP], *available at* http://ec.europa.eu/competition/mergers/cases/decisions/m3440_20041209_610_en.pdf.

149 Press Release, European Commission, Mergers: Commission Prohibits Acquisition of GDP by EDP and ENI (Dec. 9, 2004).

150 Neelie Kroes, *Improving Competition in European Energy Markets through Effective Unbundling*, 31 FORDHAM INT'L L.J. 5, 1389 (2008).

Bearing those facts in mind, it is clear that the Commission should forbid mergers that significantly impede effective competition; this is especially so in the energy sector, where markets are dominated by domestic suppliers.

The proposed acquisition of joint control over GDP by EDP and ENI was examined under the original merger regulation. In July 2004, the Commission received notice of the proposed merger. The Commission, after reviewing the notice, found that the proposed merger raised serious doubts as to the compatibility with the common market; therefore, the Commission opened an in depth-investigation of this proposed concentration. The Commission stated that the merger would lead to a strengthened dominant position of EDP and GDP in the electricity and gas markets in Portugal, as illustrated below.

The parties to the transaction consisted of two Portuguese companies, EDP and GDP, and an Italian company, ENI. EDP was the incumbent electricity company in Portugal and was active in generation, distribution and supply of electricity in Portugal.

ENI, an Italian energy company, was active at all levels of the energy and distribution chain. GDP was the incumbent gas company in Portugal, and ENI had a holding in GDP's parent company. GDP covered all levels of the gas chain in Portugal, meaning that GDP imported natural gas through pipelines to Portugal and was responsible for the transportation, storage, transport and supply of gas through a high-pressure gas pipeline network. GDP was also active in supplying natural gas to large industrial customers and in the development and future operation of the first underground natural gas storage caverns in Portugal. GDP, through a subsidiary, controlled five of the six local distribution companies in Portugal.[151]

Today, gas has become the most effective and common input for producing additional electricity in Europe. This proposed merger was vertical, because the electricity producers

[151] ENI/EDP/GDP, *supra* note 149, point I.

ENI and EDP operated in electricity markets while GDP operated in the Portuguese gas markets; the electricity producers needed gas to produce current, so the entities necessarily operated at different levels with gas as the input for gas-fired power plants. The Commission investigated, *inter alia*, possible non-horizontal effects of the proposed merger in both the electricity and gas markets.[152]

In the wholesale electricity market, the Commission found that the proposed concentration would strengthen EDP's dominant position due to the fact that the merged entity would have the ability and incentive to foreclose its competitors after the merger by increasing the price for gas supplies or lowering the quality of supply.[153] These input foreclosure effects, where the upstream gas supplier GDP would foreclose EDP's competitors in the Portuguese downstream market, were only one of the Commission's concerns. The Commission was also concerned about customer foreclosure.

As mentioned above, GDP was the dominant upstream gas supplier in Portugal, holding a monopoly in every gas market in Portugal. Furthermore, it controlled five of the six local downstream gas distribution firms in Portugal, each of which had an exclusive right to distribute natural gas within their concession area. In the merger investigation, the Commission stated that customer foreclosure was likely to occur, because, after the proposed acquisition, the dominant electricity company EDP would hold a stake of 51 percent in GDP, making it very likely that EDP would buy gas from GDP rather than from potential independent gas suppliers. Consequently, the merger would create significant entry barriers to the upstream gas market, which would make it risky for a potential rival to enter the market. Indeed, there was only one other company active in the gas downstream market besides EDP, the dominant company. This company, Turbogás, operated a combined cycle gas turbine

152 *Id*. point 365.
153 *Id*. point 411.

plant. However, this company was not independently controlled, because EDP held a 20 percent stake in Turbogás, meaning that EDP could veto actions by the Board of Directors as a minority rights shareholder. Given the strong downstream position of EDP as a significant customer, such circumstances made it quite unlikely that a potential upstream rival would enter the gas market. The Commission claimed this proposed concentration seemed likely to foreclose all gas demand from power producers and, consequently, would likely strengthen GDP's dominant position in the upstream gas markets in Portugal. The Commission also argued that, if the merger was prohibited, then it was likely that EDP would enter the upstream gas markets as a competitor to GDP. The Commission reasoned that EDP, as a large gas customer for power plants, would have the incentive to buy gas on a larger scale and sell the amount of gas that exceeded its power plants' needs. Indeed, EDP might actually gain more flexibility as a gas operator. It could decide whether to burn the gas for generating electricity or to sell the gas to customers, depending on which activity proved more profitable. EDP, without the merger, could also make dual fuel offers. It could provide customers with both electricity and gas at a competitive price by entering the upstream gas markets.[154]

At the end of its merger examination, the Commission held that the proposed merger would strengthen EDP's dominant position in the markets for wholesale electricity, retail electricity supply to large industrial customers, retail supply to low-voltage customers and ancillary services in Portugal. In the gas markets the Commission claimed that GDP's dominant position would be strengthened in the markets to supply natural gas to power plants, local gas distribution companies, large industrial customers and small customers in Portugal. Effective competition in the common market would be significantly impeded as a result.[155]

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[154] *Id*. point 505.
[155] *Id*. point 609.

Although the notifying parties submitted commitments in order to get a clearance decision, the Commission ultimately prohibited the merger.

EDP lodged an appeal against the Commission's decision to the CFI to have it annulled. The appeal was based on four pleas. One such plea was that the merger did not create or strengthen a dominant position pursuant to Article 2 (3) of the Merger Regulation.[156]

In its judgment,[157] the CFI dismissed the appeal with regard to the Commission's assessment of the energy markets and, consequently, approved the Commission's decision to prohibit the proposed merger. However, the CFI did state that the Commission made an error in assessing the merger's competitive effects in the gas markets. Due to the fact that the Portuguese gas markets, at the time the Commission's decision was adopted, were not open to competition and, therefore, were not liberalized, GDP's position in the gas markets could not be strengthened.[158]

The legal basis that competition in the Portuguese gas markets was not open was the second gas directive that allowed for a derogation of certain obligations and Member States could delay the application of the directive.[159] Portugal made use of this possibility set forth in Article 28 (2) of the second gas directive. Thus, the CFI found that the Commission made an error in law in arguing that GDP's dominant position as a monopoly could somehow be further strengthened due to the concentration. The CFI reasoned that gas markets in Portugal were not open to competition. Since GDP held a monopoly on virtually all gas markets in Portugal, such a monopoly was the ultimate dominant position that could not be further

156 Application in Case T-87/05, EDP v Comm'n OJ C 82 (April 2, 2005), p. 44.
157 Case T-87/05, EDP v Comm'n 2005 E.C.R. II-3745.
158 *Id*. point 133.
159 Directive 2003/55/EC, of the European Parliament and of the Council of 26 June 2003 Concerning Common Rules for the Internal Market in Natural Gas and Repealing Directive 98/30/EC, 2003 O.J. (L176) 57.

extended. This also implied that effective competition could not be significantly impeded in a market where there was no competition at all.[160]

Nevertheless, the CFI affirmed the Commission's decision with regard to competition concerns in the electricity markets and subsequently blocked the proposed merger. At the time the Commission's adopted its decision, the electricity markets in Portugal were already liberalized, and, consequently, the concentration had to be assessed in light of the Merger Regulation. In my judgment, the Commission was right to block the acquisition of joint control over GDP by EDP and ENI with regard to the overall likely negative impacts on competition in the electricity markets. The Commission's predictions concerning the likely entry of EDP to the Portuguese gas markets have come true. At the end of 2004, after the merger prohibition decision, EDP acquired part of Pórtgas; it now owns 72 percent of the company. The company was renamed EDP Gás, a subsidiary of the EDP group, and is active in the Portuguese gas business.[161]

C. Other non-coordinated effects

Besides foreclosure effects, vertical mergers can lead to information gains for the firms involved. For example, a downstream entity could discover sensitive information about competitors through its upstream entity being a downstream competitor's supplier; the upstream entity may have good insights into the commercial activities of the downstream competitor. The merged entity could use such information to price less aggressively and, as a

[160] Case T-87/05, EDP v Comm'n 2005 E.C.R. II-3745, point 122.
[161] *See* Energias de portugal website, EDP.pt, http://www.edp.pt/en/aedp/unidadesdenegocio/gasnaiberia/Pages/GasPortugal.aspx.

result, cause harm to consumers. The same applies in relation to information gains about an upstream competitor.[162]

VI. Conglomerate mergers

This chapter deals with conglomerate mergers, as the other form of non-horizontal mergers. Conglomerate mergers are characterized by the fact that the firms involved are neither active in the same market nor are they vertically integrated.[163] Not being active in the same market means that the firms are not competitors in the same relevant markets and are not active as either suppliers or customers, which shows that no vertical relationship exists. Instead, the firms are active in closely related markets. Usually, companies want to merge businesses that supply complementary products or products that belong to a range of goods generally bought by the same kind of customers for the same end use. In the majority of merger cases, conglomerate mergers will not lead to anti-competitive effects. However, such mergers may harm competition under certain circumstances. The Commission compares possible anti-competitive effects to pro-competitive effects in order to make a sophisticated merger decision.[164]

As set forth in the section concerning vertical mergers, possible pro-competitive effects of conglomerate mergers will first be illustrated in order to recognize why conglomerate mergers take place and to see the motivations for the involved firms to merge. It

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162 Non-Horizontal Merger Guidelines, *supra* note 5, pt. IV 78; *see also* Commission Decision on Case COMP/M.2510, Cendant/Galileo, point 37 (Sep. 24, 2001) *available at* http://ec.europa.eu/competition/mergers/cases/decisions/m2510_en.pdf.

163 Wolfgang Nothhelfer, *Wann behindern konglomerate Fusionen den Wettbewerb?*, 18 EUROPÄISCHE ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT 11, 332 (2007).

164 Non-Horizontal Merger Guidelines, *supra* note 5, pt. IV 91-92.

is necessary to evaluate both pro-competitive and anti-competitive effects, because the same considerations are made in a merger investigation.

A. Efficiency enhancing effects of conglomerate mergers

1. Definition of tying and bundling

Tying and bundling are commonly used terms in conglomerate mergers. Conglomerate firms may often be able to either sell products separately, as stand-alone components, or as tied components, which means that two products are packaged together as a take-it-or-leave-it proposition with no option to buy the products separately.[165] There are several distinguishable subcategories of bundling. Thus, it is necessary to provide a brief overview on bundling and tying, as there are often efficiency-enhancing effects for firms to sell bundled products.

a) Pure bundling

Pure bundling means that two goods are only sold together. They cannot be bought separately, and they are only offered in some fixed proportion. An example is a car: it can only be sold with a fixed proportion of one steering wheel and four tires per unit. A pure bundle is quite rare, because firms normally sell products separately, even if the price may not be attractive for consumers. For example, while it is possible to buy "Microsoft Word" and "Microsoft Excel" separately, one would rather buy the "Microsoft Office" package as the price would be more attractive. Still, there are several products that are only sold together.

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[165] Derek Ridyard, *Tying and bundling – cause for complaint*, 26 EUR. COMP. L. REV. 6, 316 (2005).

For instance, an airplane ticket often includes a meal; the customer is unable to purchase the meal and the flight separately.[166]

b) Mixed bundling

Mixed bundling occurs when a firm either sells products separately or in combination. In a mixed bundled package, a firm will sell the combined bundled package at a discount to the individual prices. The previous example with “Microsoft Office”, then, is considered a mixed bundle. One can purchase the two products separately, but the firm gives an incentive to buy it together at a discount. Another example of a mixed bundle are volume discounts. It is often cheaper for a customer to buy one bigger package of a product, such as a cereal package, instead of buying two smaller packages of the same product. Yet another form would be a simple price discount. For instance, a customer is often encouraged to buy two suits with the second suit costing only half the price.[167]

c) Tying

Tying occurs when a purchase of one product requires that customers also buy another product. The customer can then buy any quantity of the tied product once the main product is purchased. Furthermore, it is not necessary to buy the two products at the same time. A good example of tying is the purchase of copiers and toner cartridges. Once the copier is purchased, the user is often required to buy toner cartridges of the same brand; however, the user is not

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[166] Barry Nalebuff, *Bundling, Tying, and Portfolio Effects*, *in* DTI ECONOMICS PAPERS 1, point 2.1 (2003) [hereinafter Nalebuff].

[167] *Id*. point 2.2.

required to purchase toner cartridges at any fixed proportion, which means that the user can buy as many cartridges as he deems necessary.[168]

Bundling and tying can take several forms, as described above. Bundling and tying can also be distinguished as either “commercial” or “technical.” Technical bundling means that firms make two products incompatible with third party products, implying that a product will not work, or will work less efficiently, when mixed with third-party products than with a system made of two products of the same manufacturer. It is clear that technical bundling and tying can only be applied with complementary products, otherwise the components would not fit. Commercial bundling and tying are, however, the forms illustrated above, where products are bundled or tied by a contractual obligation.[169]

2. Increased pricing efficiency

There are several conceivable sources through which a conglomerate merger can lead to efficiency gains. It is not necessary that two firms merge in order to offer customers a bundle, because a bundle can also be offered through contractual arrangements. Nevertheless, contracts can lead to transaction costs and several other costs, like monitoring costs, that may make a merger more efficient by cutting off these costs. There is one inefficiency that can be completely eliminated by performing a conglomerate merger. What “double marginalization” is for vertical mergers, the “Cournot effect” is for conglomerate mergers.[170] The Cournot effect is characterised by the fact that two monopolists, if acting independently, will set an inefficiently high price for their products. If the monopolists merged their firms and took into account each other’s prices, then they could gain more profit. For example, assume two firms

[168] RBB Report, *supra* note 16, at 74.
[169] *Id*. at 75.
[170] *Id*. at 78.

sell two products: the first good is a lift ticket for a ski resort, while the second good is a ski equipment rental. If the firms merged, then the merged entity could lower lift ticket prices, which would increase sales of ski equipment rentals. Such an effect is profitable for the merged entity, because the overall profit increases. What is more, this effect is also in line with the consumer welfare standard, because consumers benefit from decreased prices. This effect causes a win-win situation, making both the merged entity and consumers better off.[171]

A firm may also try to price discriminate by bundling in order to achieve increased profits. If a firm with some degree of market power charges one price to all its customers, then the firm might face the issue that some customers are willing to pay more for the product while other customers regard the price as too high. This implies that the firm faces an overall loss, because the price is both too high, as some customers will not buy the product, and too low, as other customers value the product for more than it is selling. Firms usually try to overcome this inefficiency by bundling products. For instance, firms try to make consumers pay a "per use" fee for certain products. In the example with copiers and toner cartridges, a copier manufacturer may like to charge a high price to intensive users who value the product more than infrequent users. The manufacturer could increase prices for toner cartridges and lower prices for copiers, which would have the effect that customers who use the copier intensively will pay more than customers who are not such frequent users. Importantly, this method only works when goods: 1) can only be used together, 2) are not used in fixed proportions, and 3) are tied together such that consumers cannot change and use components from different manufacturers.[172]

[171] Nalebuff, *supr*a note 166, point 4.3.2.2.
[172] RBB Report, *supra* note 16, point 4.2.2.

3. Improved productive efficiency

A conglomerate merger often takes place due to cost savings effects. Indeed, when facilities from both entities are commonly used there can be economies of scope effects such that a merger leads to reduced production costs.[173] One example would be a conglomerate merger in which a car manufacturer merges with a motorcycle manufacturer, allowing both firms to share a wind tunnel for aerodynamics testing. Such shared use could increase the efficiency of this asset.[174] Generally speaking, bundling products gives rise to cost saving effects and/or better product quality. For example, bundling is common in the automotive industry. It is less expensive for a car-maker to assemble a car than for the customer to buy the components separately and assemble them at home. A car is bundled with hundreds of components like engines, gears, tires and so forth. Another reason bundled products are common is the problem of choice itself. Sometimes customers are overstrained by too much choice. Too much choice can actually lead customers to be overwhelmed and to postpone making a decision. Thus, it can be a profitable strategy for a firm to offer a bundled package such that customers are not overwhelmed and do not delay purchases. In addition to such cost saving effects of bundling that result from a merger, another effect is often value enhancement. For instance, after a customer buys both a computer and a printer, it is possible that the printer might not work with the computer. A question might then arise about whether the fault lies with the printer or with the computer. If the customer bought the computer and printer as a bundled package, then the customer would only have to call one telephone number, normally the dealer's, to get to the bottom of the problem. Another more complex example would be the relationship between a person's automobile and medical insurance

[173] Gary Hewitt, *Portfolio Effects in Conglomerate Mergers, in* ORG. ECON. COOPERATION & DEV., BEST PRACTICE ROUNDTABLES IN COMP. POL'Y 37, 88 (2002).

[174] RBB Report, *supra* note 16, at 95.

policy. It is possible that the policies might overlaps or have gaps. So, if both products were sold together, then the policyholder should be less concerned since only one company is responsible when damage occurs. This means that there would not be separate companies, where each one tries to hold the other liable for the damage compensation.[175]

As these examples show, bundling can have more incentives for firms than simply cost saving effects alone. However, cost saving effects still play the dominant role when two companies consider merging. Human capital is another important cost saving factor. Economies of scope are typical in these mergers, especially in R&D activities. Highly specialized personnel are usually able to transfer their expertise and experience in related markets. For example, pharmaceutical researchers can engage in research on drugs for different diseases. In addition to human capital, there are also immaterial assets to consider, such as brand names, reputation and so forth. An example of this is the conglomerate expansion of the Virgin group. The group has the ability to transfer its well-known brand name to each new market it enters. In principle, all of the above can be achieved without a merger. Firms could lease human capital or franchise brand names. However, such contracts are often difficult to specify and costly to enforce. In these cases, a merger can create big efficiency gains.[176]

Conglomerate mergers may also allow firms to share financial risks. For instance, a firm that is active in manufacturing heating equipment may expand its business into manufacturing air conditioning equipment in order to be prepared for unusually hot or cold years. Another strategy is that a firm could expand into unrelated markets. For example, a manufacturer of razors could expand into the men's toiletry market.[177]

[175] Nalebuff, *supra* note 166, point 4.3.1.
[176] RBB Report, *supra* note 16, at 95-96.
[177] *Id*. point 4.3.2.

In addition, increased buying power could result when the merging firms use the same inputs for their businesses. After the merger closes, the merging parties would probably get larger volume-discounts, which would reduce total costs. This increase in buying power always benefits the merged entity. Such cost reduction can then be passed on to consumers, depending on the structure of the downstream market. However, consumers can also be harmed when a merged entity with buying power reduces input purchases in order to knock down input prices. Such countervailing buying power does not necessarily require a merger to work properly, as it can also be obtained by common procurement. For instance, it is common practice for US private hospitals to pool purchases into a single tender for a long-term exclusivity contract in order to get large price reductions from pharmaceutical companies.[178]

4. Prevented profit expropriation

If a firm sells a product that only works in combination with other products, then the demand for each component of the product will depend on the quality of each component used as consumers normally only see and assess the combined product altogether. For example, this is the case when a system is sold, as it was in the HILTI case.[179] In such a case, where a customer evaluates the quality of a product as a whole, even one small part of the product that is of bad quality could lead to a bad reputation for the whole. Consequently, firms often seek to gain control over a reliable supplier's product by bundling their product with the supplier's product to ensure an entire product of utmost quality.[180]

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178 *Id*. point 4.3.3.

179 Commission Decision 88/138/EEC, of 22 December 1987 Relating to a Proceeding Under Article 86 of the EEC Treaty (IV/30.787 and 31.488 - Eurofix-Bauco v. Hilti), 1988 O.J. (L 65), 19-44.

180 RBB Report, *supra* note 16, point 4.4.1.

In 1988, HILTI, a Liechtenstein-based company, was punished with a 6 million ECU fine by the Commission due to infringement of ex-Article 82 EC Treaty (now Article 102 TFEU), which covers abuse of a dominant position. HILTI produced nail guns that use exploding cartridges to propel a nail, which is then driven into concrete or other fastening material. HILTI was accused of refusing to sell cartridges to independent producers of nails such that the nails could not be used with HILTI nail guns. As a result, the independent nail producers alleged that HILTI abused its dominant position by tying its cartridges to its nail guns. HILTI defended itself by arguing that, due to reputation and safety concerns, it had to tie the cartridges and nails to the nail gun, because independent nail producers might manufacture error-prone nails that are highly risky to use in HILTI nail guns. Thus, HILTI was afraid of being accused by consumers that they had bad quality nail guns, even if it was just the nail's failure. However, HILTI's argument was not approved, and they were, consequently, forced to cease such anti-competitive behavior.[181]

What HILTI did in this case was pure bundling. However, there are several other ways to achieve high quality complementary products. The firm, for example, could disclaim any liability if its product is combined with third-party products, such as with nails from independent producers. However, such an announcement has to be advertised, which might give rise to high costs and may nevertheless be insufficient to protect the brand's reputation. To obtain these aims, a merger is not stringently necessary, but firms may find it the fastest and most cost effective way to ensure product quality.[182]

As is the case for vertical mergers, conglomerate mergers are also common in terms of R&D. If two firms are engaged in R&D activities, a firm might fear that a third-party

[181] Barry Nalebuff, *Bundling, Tying, and Portfolio Effects, in* DTI ECONOMICS PAPERS, PART II: CASE STUDIES, pt. III (Feb. 2003).

[182] RBB Report, *supra* note 16, point 4.4.1.

company could obtain too much sensitive information from leaks in an involved company. In particular, the development of high-tech products needs close collaboration between the involved companies. If a firm active in R&D acquires a third-party competitor, then this acquisition may be a possible solution for information spillovers. R&D activities are especially important and mutually useful for involved companies with regard to complementary products. For instance, if a computer manufacturer increases a computer's speed, then this development may also have positive effects for a software producer such that the software's value increases. The reason this might happen is that faster software is generally more valuable from a consumer’s perspective.

A problem often arises that the firm, which has invested in innovation, is not able to fully exploit its profit potential, because complementary firms have taken advantage of these investments without expending any costs. For instance, the software producers in the above example might gain profit at the expense of the innovative firm. If these two firms merged, then the innovative firm would also profit from the increased sales of the software producer. Another incentive to merge, under those circumstances, is that the market share of remaining independent producers will be reduced after the merger, and/or the remaining independent producers may have smaller gross margins due to the merger.[183]

5. Incomplete contracts and transaction costs

This next issue, as illustrated in the chapter on efficiency enhancing effects for vertical mergers, is nearly the same for both vertical and conglomerate mergers. While conglomerate integration can also be achieved through contracts, such contracts can induce high costs, like monitoring, agency, and other costs, that would be eliminated after a merger. Indeed, so-

183 RBB Report, *supra* note 16, at 101-102.

called “one-stop-shopping” can be a source of efficiencies in a merger. A good example are gas stations that sell newspapers and other goods. It is cheaper for such a retailer to negotiate with only one wholesaler than to negotiate with many wholesalers. If gas retailers’ costs are contained, then these reduced costs may be passed on to consumers. What is more, even when the goods are complementary, one-stop-shopping may lead to consumer advantages. If a consumer buys a car from a manufacturer that is integrated with a financial company, then reduced contractual costs may involve cost-saving car purchases to the consumer's benefit. Whether such gains are passed on to consumers, then, certainly depends on the intensity of competition in the specific market. Markets with intense competition are more likely to pass on such gains than markets in which a merged entity does not face enough competition. Although such one-stop-shopping advantages can often be achieved through contracts, a merger may be useful when a company is faced with bargaining troubles.[184]

B. Non-coordinated effects: foreclosure

Foreclosure is the main concern surrounding conglomerate mergers. Foreclosure can be achieved by leveraging a strong market position from one market to another. Although there is no specific definition for “leveraging,” it generally means that a firm increases sales in one market through tying or bundling to another market. As described above, bundling and tying can have pro-competitive effects, which means that better products or more cost-effective services can be offered to the benefit of consumers. Still, anti-competitive effects are possible, which may weaken competition and reduce the competitive pressure on a merged entity. If a merged entity faces reduced competitive pressure, then it may have an increased

[184] *Id*. point 4.5.

incentive to advance prices on its products. Thus, the Commission applies the same steps to examine the possible anti-competitive effects with conglomerate mergers as it does with vertical mergers. First, it examines whether the merged firm will have the ability to foreclose rivals. Second, it examines whether the merged firm will have an incentive to apply a foreclosure strategy. Lastly, the Commission assesses whether such a foreclosure strategy will have a significant detrimental effect on competition and, consequently, will harm consumers.[185]

1. Ability to foreclose

Bundling and tying are methods by which a merged entity can foreclose competitors. However, the merged entity must have a significant degree of market power in at least one of the markets concerned in order to raise competition concerns. As a result, it is necessary that the merging parties' products are regarded by many customers as particularly important and that there are not many alternatives to the product. This can be achieved through product differentiation where particularly important products are called “must stock” products.[186] In the Procter&Gamble/Gillette[187] merger, the merging parties owned so-called “must stock” brands. These are brands with a strong spontaneous demand that most retailers have in stock. In the case of Procter&Gamble, such brands were Ariel, Pringles, Pampers, Head & Shoulders and many others. Gillette's brands included Oral B, Duracell, Braun, and Gillette razors and blades. If the two firms merged, then they would own 21 brands with a turnover of more than one billion dollars.[188] In this case, it was assumed that there were a significant number of

[185] Non-Horizontal Merger Guidelines, *supra* note 5, pt. V 93-94.
[186] *Id*. pt. V 99.
[187] Commission Decision on Case COMP/M.3732, Procter&Gamble/Gillette (July 15, 2005) *available at* http://ec.europa.eu/competition/mergers/cases/decisions/m3732_20050715_20212_en.pdf.
[188] *Id*. point 111.

customers who wished to buy the products, indicating the importance of bundling or tying. The more customers tend to buy both products, instead of buying just one of them, the more demand for the separate products may be affected through bundling or tying. This is more likely to happen when the concerned products are supplementary. Foreclosure effects are usually smaller when a bundling or tying strategy is not long-lasting, such as through technical bundling or tying that is costly to reverse.[189]

The Commission also has to examine possible counter-strategies that rivals may adopt in order to strengthen their competitive position. Bundling is less likely to occur where, for example, two rivals are also able to combine their products and sell them at more attractive prices to customers. Rivals could also try to price more aggressively in order to maintain or increase market share. The fact that customers may want to buy products from a single source, rather than many different suppliers, is referred to as one-stop-shopping. If firms have a broad product portfolio to offer, then bundling or tying may be a more attractive strategy to employ. However, the mere fact that firms have a broad product range does not in itself lead to competition concerns.[190]

2. Incentive to foreclose

There are several reasons for firms to engage in bundling or tying. One reason is increased efficiency. These effects were demonstrated in the chapter on efficiency-enhancing effects of conglomerate mergers. Another reason is firms may have strategic incentives to enlarge the merged entity's market shares and gain competitive advantages over rivals.

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189 Non-Horizontal Merger Guidelines, *supra* note 5, pt. V 100, 102.
190 *Id*. pt. V 103, 104.

For instance, a merged entity could use its strong position in one product market to transfer this position to the complementary market by means of undercutting rivals' prices. This activity can be quite profitable; if rivals are unable to reduce prices, then the merged entity would have a competitive advantage, as it would increase sales. However, rivals may respond to those price decreases, offsetting any potential gains for the merged entity. However, as Barry Nalebuff[191] stated, firms that bundle have an advantage over their rivals in most cases, because even if the merged entity loses money, their rivals tend to lose more.[192] Bundling and tying can also lead to losses due to changed consumer behavior. If customers are not interested in buying the bundled products but, instead, only buy one product instead, then sales of the other product may substantially drop. In addition, customers may, prior to the merger, be used to mixing and matching a rival's product with another firm's product. After the merger closes, customers may not be able to combine one product from one producer with a rival's product due to the bundling or tying strategy of the merged entity. These customers are likely to either switch to rivals that allow products to be interchanged or to not make such purchases at all.[193]

Such issues were raised in the merger between General Electric (GE) and Amersham.[194] GE is a company active in various businesses including medical systems.

GE Medical Systems specializes in medical diagnostic imaging technology and related services and health care products. Amersham produces diagnostic pharmaceuticals, namely, contrast agents and radiopharmaceuticals. In its merger examination, the Commission assessed various factors, including bundling strategies. The Commission was feared that

[191] Barry Nalebuff, Professor of Economics and Management at Yale School of Management.
[192] Nalebuff, *supra* note 166, point 4.4.1.
[193] Non-Horizontal Merger Guidelines, *supra* note 5, pt. V 103, 106.
[194] Commission Decision on Case COMP/M.3304, GE/Amersham, (Jan. 21, 2004) *available at* http://ec.europa.eu/competition/mergers/cases/decisions/m3304_en.pdf.

Amersham's diagnostic pharmaceuticals would only work with GE's medical diagnostic imaging systems after the merger. After concluding its investigation, however, the Commission found that this technical tying strategy was unlikely to take place. The Commission reasoned that if Amersham's products exclusively, or most optimally, worked with only GE equipment, such that competitors' access to data might be denied, then such a strategy would have had a negative effect on Amerham's sales of products to the installed base of competing diagnostic imaging equipment.[195] Thus, in that case, a foreclosure strategy through bundling would not have been profitable, because bundling Amersham's products to GE's products would likely lead customers, like hospitals, to buy from other companies.

Another incentive for firms to engage in foreclosure through bundling is to create entry barriers for competitors. Bundling can be a particularly effective method of deterring potential entrants. A good example is Microsoft Office, which bundles Word, Excel, PowerPoint and Outlook together into a software package. If a consumer wants to assemble his or her own bundle, then the consumer could take the “best” commercial products available; for example, the customer could combine Microsoft's PowerPoint with Corel's Word Perfect andIBM's Lotus 123. On the other hand, if a customer only values one product, such as a text editor, then the customer would only have to choose between Microsoft's Word or another commercial product like Corel's Word Perfect. Thus, the customer could either buy Microsoft's Word or other products. However, in the case of a customer valuing two products, such as a text editor and a spreadsheet program, the customer would most likely take the bundle. The customer probably finds this choice more attractive not only because of price, but also due to the availability of a one-stop-shop helpline in case of product errors.[196]

[195] *Id*. point 59.
[196] Nalebuff, *supra* note 166, point 4.4.2.

Bundling also creates competitive advantages through variety bundles. A variety bundle is where a customer wants to have variety but consumes only one variety at a time. A good example is a ski resort, which often includes several mountains in the price. Offering customers a wide variety will attract many more skiers than if the mountains were priced separately. The same applies to restaurants, where a large number of competing restaurants are in close proximity to each other. Chinatown restaurants in London present such an example. While they are directly adjacent and, therefore, compete with each other, it is nonetheless more profitable for each restaurant to be within close proximity to each other, because many more customers are attracted to these areas than would be the case without the proximity.[197]

Whether firms have an incentive to foreclose rivals also depends on the relative value of the different products. This implies that firms are not inclined to pass up sales in highly profitable markets in order to improve market share in other markets that are not as profitable. When evaluating conglomerate mergers, the Commission also takes into account the ownership structure, past strategies in the market, and internal documents like business plans. This procedure is the same with vertical mergers, so it requires no further description.[198]

3. Overall likely impact on prices and choice

While conglomerate mergers in most cases lead to pro-competitive effects due to increased efficiencies that result in better product quality and/or lower prices, there are still circumstances that lead to a reduction of competition to the detriment of consumers. Bundling and tying can reduce rivals' sales, which is not in itself a problem, but this reduction in

[197] *Id*. point 4.4.4.1.
[198] Non-Horizontal Merger Guidelines, *supra* note 5, pt. V 107, 109.

particular industries can result in a shortened ability or incentive for rivals to compete. Therefore, the merged entity may enlarge its market power in the market for both the bundled and/or tied good as well as for the tying or leveraging good.[199] Such anti-competitive effects were raised by the Commission in the Guinness/Grand Met[200] Case.

Guinness, one of the world's leading suppliers of spirits, was active in producing and distributing spirits as well as brewing beer. Grand Met was also active in worldwide production and distribution of spirits and was, in addition, active in the fast food industry as the owner of Burger King. The operation was aimed at combining the two parties' businesses to create GMG. Due to their strong positions in the market, these firms offered a plethora of alcoholic drinks to customers. Guinness held a dominant position, especially in the Greek market, for sales of whisky, gin and rum. Grand Met was strong in the market for brandy, ouzo, tequila and liqueurs. The Commission's main concern was that these two firms would hold a dominant position in all spirits sales after the merger. The fact that rivals would not have such a broad portfolio of spirits implied an overall likelihood that consumers would purchase from the merged entity due to its breadth of choices. This would then reduce rivals' ability to effectively compete in the markets for spirits. However, the merger was eventually allowed due to conditions imposed on the merging parties.[201]

This case was decided under the original merger regulation that used the dominance test rather than the new SIEC test (significant impediment to effective competition test). Under the SIEC test, foreclosure is an issue when potential competitors are kept from entering the market. For example, if rivals will be de facto forced to enter both markets, the one product market and the tied/bundled product one, in order to remain competitive due to the

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[199] *Id*. pt. V 111.

[200] Commission Decision on Case COMP/M.938, Guiness/Grand Metropolitan, 1998 O.J. (L 288) 0024-0054.

[201] *Id*. points 115-117; MONTI, *supra* note 8, point 5.1.

merged entity’s dominant position, this the Commission would likely oppose the merger. Indeed, entering two markets may be costly and only a viable option for big firms.[202]

Nevertheless, foreclosure is only a concern when it affects a large fraction of market output. Thus, if other effective competitors remain in the markets after the merger closes, then competition most likely will not be impeded. The Commission may look to whether remaining competitors are able to expand output after the merger as an indication that foreclosure has not affected competition. In its competitive assessment, the Commission also examines whether significant countervailing factors exist and whether the merging parties claimed any efficiencies resulting from the merger.[203]

As these considerations are similar to vertical mergers and efficiencies surrounding conglomerate mergers and, consequently, have already been explained in a separate chapter of this thesis, one can refer back to the specific chapter on efficiency-enhancing effects of conglomerate mergers for more information.

4. Case studies

One of the most prominent conglomerate merger cases was the prohibited $42 billion merger between General Electric (GE) and Honeywell.[204] It was the second merger case in which the Commission prohibited a merger that only involved American firms.[205] This proposed merger was investigated both by the European Commission and the U.S. Department of Justice due to its territorial scope. Not surprisingly, this case was a very high-

[202] Non-Horizontal Merger Guidelines, *supra* note 5, pt. V 112.
[203] *Id*. pt. V 113-115.
[204] Commission Decision on Case COMP/M.2220, General Electric/Honeywell, (July 3, 2001) [hereinafter General Electric/Honeywell], *available at* http://ec.europa.eu/competition/mergers/cases/decisions/m2220_en.pdf.
[205] *See* Press Release, European Commission, The Commission Prohibits GE's Acquisition of Honeywell (July 3, 2001).

profile case, especially in light of the fact that the Commission and the U.S. Department of Justice eventually came to opposite conclusions about the merits of the merger. Thus, the proposed merger was prohibited by the European Commission, with respect to the European markets, and cleared by the U.S. Department of Justice, with respect to the U.S. markets.[206]

On February 5, 2001, the Commission received notice of a proposed concentration in which the General Electric Company ("GE"), a U.S. company, had agreed to purchase all of the shares of Honeywell International Inc. ("Honeywell"), another U.S. company. GE was a diversified industrial corporation active in many fields, including aircraft engines, appliances, information services, and financial services. Honeywell, likewise, was active in many sectors, including the manufacture of aerospace products and services and electronic materials.[207] At the time, GE was the leading aircraft manufacturer, while Honeywell was the leading avionics/non-avionics manufacturer. The Commission's concerns were that, due to these strong market positions, the two firms could further create or strengthen their dominant positions in the relevant markets after the merger. GE had a dominant position in the engine markets for both large commercial and large regional jet aircraft. After the merger, Honeywell could have used GE's dominant position to benefit its product portfolio and boost sales through bundling.[208]

One major reason why GE had a dominant position in the market for engines was that GE was vertically integrated into aircraft purchasing, financing and leasing and had significant financial strength through GE Capital. GE Capital was a subsidiary of the GE

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[206] William Kolasky, Deputy Assistant Att'y Gen., DOJ, U.S. and EU Competition Policy: Cartels, Mergers, and Beyond (Jan. 25, 2002) [hereinafter Kolasky], *available at* http://www.justice.gov/atr/public/speeches/9848.htm; *see generally* Michael Elliott, *The Anatomy of the GE-Honeywell Disaster*, *in* TIME MAG. (July 8, 2001) *available at* http://www.time.com/time/printout/0,8816,166732,00.html.

[207] General Electric/Honeywell, *supra* note 204, points 1-4.

[208] Gotz Drauz, *Unbundling GE/Honeywell: The Assessment of Conglomerate Mergers under EC Competition Law*, 25 FORDHAM INT'L L.J. 4, 897-898 (2002) [hereinafter Drauz].

group and was a major financial organization.[209] At the time of the merger decision in 2001, GE had the world's largest market capitalization at $480 billion and, as a result, was far larger than its competitors Boeing and UTC who had market capitalizations of $56 billion and $39 billion, respectively. GE Capital was the financial arm of the GE group; it contributed about half of the GE corporation's consolidated revenues, and it managed $370 million of the GE corporation, more than 80 percent of GE's total assets. This implies that if GE Capital were an independent company, then it would rank in the Top 20 of the Fortune 500 largest corporations.[210] In its investigation, the Commission found that GE could engage in financially risky product development programs due to its financial strength; its competitors, on the other hand, would not have the same financial means to engage in such a strategy. Thus, GE could absorb product failures and would not need to fear any negative impacts on competition. Moreover, GE could grant large discounts on products due to its financial strength, while competitors could not afford, or would require significant external funds and costs, to do the same. As a result, GE would make its competitors vulnerable to any economic slump or strategic mistake. The Commission further found that GE used its financial strength to invest large amounts of money into the aftermarket by purchasing repair shops all over the world. These repair shops were not limited to repairing GE's own engines, as they also repaired competitors' engines. Since revenues from such repairs benefited GE, the Commission found that competitors would also face losses in the shrinking servicing market. All these considerations led the Commission to assume that a foreclosure strategy would be triggered by GE's financial strength.[211]

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[209] *Id*. at 898.
[210] General Electric/Honeywell, *supra* note 204, point 107.
[211] *Id*. point 1.B.3(1).

Another reason GE was dominant was the fact that it was vertically integrated in aircraft purchasing, financing and leasing activities through GE Capital Aviation Services ("GECAS"). GECAS was the largest purchaser of new aircraft ahead of any individual airline. It had the largest single fleet of aircraft with over 1000 units. Indeed, GECAS was twice as big as its direct competitor in terms of aircraft fleet. GECAS was also one of the two leading leasing companies that bought aircraft on a speculative basis. As GECAS belonged to the GE group, it was small wonder that GECAS favored GE engines when it bought aircraft. This was the reason why 99 percent of the large commercial aircraft ordered by GECAS had GE engines installed. Due to these circumstances, the Commission found that GE held a dominant position in the markets for large commercial jet aircraft and large regional jet aircraft engines and had the ability to foreclose competition, which could lead GE to behave independently from its competitors, customers and, finally, consumers.[212]

GE's strong position would have been useful for Honeywell after closing the merger, because Honeywell could have taken advantage of GE's financial strength. Honeywell's product sales would have also increased due to GECAS' role as the leading purchaser of aircraft; GECAS would have had a strong incentive to foster the sale of Honeywell's avionics and non-avionics products as it did with GE's engines. After the merger, Honeywell would have become the dominant supplier in the avionics and non-avionics market, a sector where it already had leading positions and a high market share. Honeywell's competitors would have been marginalized after the merger, which would have then led to shrinking revenues for competitors and a reduction of their ability to invest for future developments. This would ultimately have been detrimental to innovation, competition and consumer welfare.[213]

[212] *Id*. points 1.B.3(2), 229.
[213] Drauz, *supra* note 208, at 902.

These were basically the concerns that the Commission described to the notifying parties.

After the concerns were made known to the parties, GE submitted a proposal for a package of undertakings to address the Commission's competition concerns. The proposal contained structural undertakings related to avionics and non-avionics products, engine starters, small marine gas turbines, large regional jet engines. It also contained a commitment to not engage in product bundling. However, the Commission found that these commitments were not sufficient to eliminate the competition concerns. In its overall conclusion, the Commission stated that the proposed merger would lead to the creation or strengthening of a dominant position in the markets for large commercial jet aircraft engines, large regional jet aircraft engines, corporate jet aircraft engines, avionics and non-avionics products, and small marine gas turbines that would result in significant impediments to effective competition.[214] For this reason, the Commission blocked the merger.

However, the merging parties appealed this decision. In its judgment, the CFI came to the conclusion that the Commission's conglomerate effects analysis was wrong. First, the CFI investigated whether the Commission's analysis proved that GE's financial strength and vertical integration would lead to a dominance for the merged entity in the markets for various avionics and non-avionics products. The CFI found that the Commission did not provide sufficient evidence that the merged entity would have become dominant by using its financial strength to favor Honeywell's products. Furthermore, the CFI found that the Commission had failed to examine the cost to the merged entity of promoting Honeywell's products. Thus, the CFI thought that the Commission was not entitled to assume that such a promotion would take place.[215] The CFI then analyzed the Commission's findings

[214] General Electric/Honeywell, *supra* note 204, point 567.
[215] Case T-210/01, General Electric Co. v Comm'n, 2005 E.C.R. II-5575, recitals 335-338.

on whether the merged entity would engage in bundling. The CFI showed that it was not sufficient for the Commission to examine whether the merged entity would be able to engage in bundling practices, the Commission also had to show that bundling was likely to occur after the merger - based on convincing evidence.[216]

With regard to pure bundling, the CFI opposed the Commission's analysis. The Commission's point of view was that the merged entity would refuse to sell the engine or other important components unless the customer also purchased other products. The CFI criticized the fact that the Commission failed to carry out a sophisticated analysis of the specific products that such a strategy might involve. The major reason the CFI rejected the Commission's analysis with regard to conglomerate effects was that the Commission did not provide concrete examples on the bundling issues and did not carry out detailed analyses. Consequently, the CFI found that the Commission's conglomerate effects analysis was wrong.[217]

Although the conglomerate effects analysis was carried out incorrectly, the CFI still upheld the Commission's decision; it shared the view that, following the merger, the applicant's pre-existing dominant position in the market for jet engines for large regional aircraft would be strengthened. Dominant positions would also have been created in the markets for engines for corporate jet aircraft and for small marine gas turbines.[218]

Thus, the Commission's decision was finally upheld by the CFI due to horizontal effects and both applications were dismissed.[219]

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[216] *Id*. recital 405.

[217] James Killick, *The GE/Honeywell Judgment – In Reality Another Merger Defeat for the Commission*, 28 EUR. COMP. L. REV. 1, 56-57 (2007).

[218] General Electric Co. v Comm'n, 2005 E.C.R. II-5575, recital 732; *see also* Case T-209/01, Honeywell Int'l, Inc. v Comm'n, 2005 E.C.R. II-5527.

[219] *See* David Howarth, *The Court of First Instance in GE/Honeywell*, 27 EUR. COMP. L. REV. 9, 485 (2006).

In 2007, GE acquired Smiths Aerospace, which had a similar product portfolio to Honeywell.[220] As this case shows, a merger can be blocked in one jurisdiction while it can be cleared in another. The central issues of this case may not have dealt with a diverging understanding of fundamental principles of competition law between the USA and Europe; rather, the central issues of this case dealt with how to apply them in practice. The same can apply in a single state, where, given the same facts, a court or an authority can come to a different conclusion than another court.

In this case, the US Department of Justice ("DOJ") came to opposite conclusions on nearly every issue. GE's position in the global market for aircraft engines was not considered dominant by the DOJ. Second, the DOJ denied that bundling of avionics and non-avionics systems with aircraft engines would lead to a successful exclusionary strategy in a market with large and sophisticated buyers like Boeing and Airbus. Third, the DOJ did not find that GE's vertical integration would give rise to foreclosure. Fourth, the DOJ did not expect that GE's financial strength would result in harm to competition by enabling Honeywell to invest more in R&D and to offer lower prices to customers than its rivals. Lastly, the DOJ did not find that these price cuts would force rivals to exit the market. Every single point was negated by the US DOJ and affirmed by the European Commission.[221]

Although this case was applied under the original merger regulation where the concept of dominance was a major factor to consider in addition to impediments to effective competition, it is worth considering whether the merger could have been assessed differently if the new SIEC test would have been in effect at the time of the merger decision. The major difference between the old dominance test and the new SIEC test is that a formal finding of dominance is no longer required. This new approach is particularly relevant in oligopolistic

[220] *See* GE Aviation Systems, WIKIPEDIA.ORG, http://en.wikipedia.org/wiki/Smiths_Aerospace.
[221] Kolasky, *supra* note 207, at 6.

markets, where a single dominant firm might not exist, but competition can still be impeded by a merger.[222]

If one agrees with the European Commission's finding on the case that found that GE was dominant in aircraft engine markets, then, under the new SIEC test, one only has to consider whether the proposed merger would significantly impede effective competition after the merger. Thus, the Commission would also probably block the merger under the new SIEC test, provided that it relied on the same facts. One must also assume that the commitments given by the parties were the same. On the other hand, if one agreed with the US Department of Justice's findings, where GE was not considered dominant, then one would also have to examine whether the merger would significantly impede effective competition and might in fact come to another finding. This is a difference from the old dominance test. Where dominance was not an issue, no competition concerns would be raised under the old test. However, under the new SIEC test, even if no dominant position is found, a closer look must still be taken at the second criterion dealing with significant impediments to effective competition.

It would be easier to perform such an investigation if the market share examination resulted in a market share below 30 percent, which the Commission considers a "safe haven" under which no competition concerns are raised.[223]

Another prominent conglomerate merger prohibition decision was the prohibited merger between Schneider and Legrand.[224] What makes this merger case so unique is not only the fact that the CFI annulled the Commission's decision, but also the fact that the CFI ordered the Commission to pay compensation for damage incurred by Schneider for not being

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222 BELLAMY & CHILD, *supra* note 36, pt. 8.197.

223 *See* Chapter IV for a more comprehensive presentation.

224 Commission Decision on Case COMP/M.2283, Schneider/Legrand, 2004 O.J. (L101) [hereinafter Schneider/Legrand].

allowed to merge with Legrand.[225] For these reasons, it is worth taking a deeper look at this case.

Both companies, Schneider Electric and Legrand, were French companies with worldwide activities. Schneider was active in the business of producing and selling products and systems in the electricity distribution, industrial control and automation sectors. Legrand, on the other hand, was active in producing and selling low-voltage switchgear and accessories. In order to acquire Legrand, Schneider announced a public offer of exchange of shares in January 2001, while the Commission was notified of the proposed merger in February 2001.[226] Generally speaking, it was not possible for a concentration to be implemented until the Commission declared the concentration to be compatible with the common market. However, under the old merger regulation that was applied to this case, Article 7 (3) granted an exemption insofar as it allowed implementation of a duly notified public bid under the premise that the acquirer did not exercise voting rights until after clearance was obtained. In this case, Schneider legally owned more than 98 percent of Legrand's shares when the Commission opened an in-depth investigation into the case.[227] In its merger investigation, the Commission analyzed all relevant product and geographic markets, such as: the markets in moulded case circuit breakers in Italy, the markets for earth leakage protection in Denmark, Spain, Italy and Portugal, the markets in transformation equipment, and the markets in control and signalling units in France. The Commission compared the competition situation in those markets before and after the merger would have

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[225] *See Commission Must Compensate Schneider for Illegal Merger Prohibition*, EU FOCUS 215, point 8 (2007); Judgment T-351/03, Schneider Electric v Comm'n, (July 11, 2007), available at: http://curia.europa.eu/juris/document/document.jsf?docid=62284&mode=req&pageIndex=1&dir=&occ=first&part=1&text=&doclang=EN&cid=121514.

[226] Schneider/Legrand, *supra* note 224, point I; *see also* Press Release, European Commission, Commission Prohibits Acquisition of Control of Legrand by Schneider Electric (Oct. 10, 2001).

[227] John Lang, *Two Important Merger Regulation Judgments: The Implications of Schneider-Legrand and Tetra Laval-Sidel*, 28 EUR. L. REV. 2, 260 (2003) [hereinafter Lang].

been closed. Consequently, the Commission found that the notified transaction would have strengthened a dominant position in several markets, especially those in France. The Commission remarked that both firms would - post-merger - be able to take substantial advantages over its rivals such that the merged entity would be in a position to control competition in the French market. Indeed, it could increase prices of products without losing market share; furthermore, the merged entity could increase prices of products that were sold under only some of its brands such that the decrease in demand for those products would increase demand for its other brands. The Commission, moreover, did not see any countervailing buying power that could balance the merged entity's strength in the relevant market. As a result, the Commission held that the transaction would strengthen a dominant position with the effect of significantly restricting competition in several markets.[228] Confronted with these findings, Schneider/Legrand submitted remedies in order to get a clearance decision. However, the Commission rejected the proposals as insufficient to re-establish competition. This was based on the finding that Schneider/Legrand would have retained ownership of and access to all the technologies used by the planned entities. Moreover, the Commission also rejected the second proposal from Schneider/Legrand, because it was submitted late and the divested businesses would not have enough access to distribution in France. So, the Commission passed a second merger decision that ordered the divestiture of the implemented merger.[229]

Schneider lodged an appeal to the CFI to annul both the merger prohibition decision and the divestiture decision.[230] The CFI came to two conclusions that allowed it to annul the Commission's decisions. First, it challenged the Commission's economic analysis regarding

[228] Schneider/Legrand, *supra* note 224, point 781-783.
[229] *Id*. point 790; Lang, *supra* note 227, at 261.
[230] *See* Case T-310/01, Schneider Electric SA v Comm’n, 2002 E.C.R. II-4071; *see also* Case T-77/02, Schneider Electric SA v Comm’n, 2002 E.C.R. II-4201.

the relevant markets apart from the French sectoral markets. Second, it found a serious infringement of Schneider's defense rights concerning the French sectoral markets. With regard to the first point, the CFI found that the Commission's economic analysis was only well-grounded with regard to the French sectoral markets, and, thus, the CFI acknowledged anti-competitive effects of the concentration. However, the Commission highlighted the national dimension of the geographical markets in order to illustrated strengthening or creation of a dominant position for the merged entity. What is more, the Commission based its competitive assessment of the operation on transnational, global considerations that were only extrapolated from a single market. As a result, the CFI criticized the Commission for not having examined the markets carefully enough. Instead, the CFI thought that the Commission should have made a precise country-by-country investigation of the affected markets. With regard to the French markets, the CFI agreed with the Commission that the merger would create or strengthen a dominant position. However, also with regard to the French markets, the CFI found a procedural irregularity that created an infringement of defense rights insofar as there was a discrepancy between the Commission's statement of objection and its decision. In its statement of objections, the Commission pointed out an "overlapping" of Schneider-Legrand's activities in certain markets and a strengthening of Schneider's market position, while the Commission's final decision emphasized the parties' strong positions in "associated" markets.[231] Consequently, Schneider did not get the opportunity to extensively respond to the Commission's statement of objections and could neither challenge the substance of the Commission's arguments nor submit proper remedies to eliminate competition concerns. Therefore, Schneider's defense rights were infringed, and the CFI, consequently, annulled the Commission's decisions.[232]

[231] Press Release No 84/02, Court of First Instance (Oct. 22, 2002); *see also* Lang, *supra* note 228, at 262.
[232] Schneider Electric SA v Comm'n, 2002 E.C.R. II-4071, point 452-456.

However, in 2003, Schneider filed a suit against the Commission in order to be compensated for damages incurred due to the Commission's decisions with which it was forced to comply. Schneider claimed that its main damage derived from the financial loss it suffered by being forced to sell assets in Legrand at a lower price than it originally paid to purchase them. Eventually, the Court awarded compensation to Schneider.[233]

However, the Commission appealed CFI's judgment to the Court of Justice, which then set aside the judgment in part. The Court of Justice found that there was no direct causal link between the price reduction at issue and the illegality vitiating the Commission's negative decision.[234] Still, the Community, represented by the Commission, was ordered to compensate Schneider for expenses incurred with respect to resuming the merger control procedure.[235]

What was remarkable about the Schneider/Legrand merger was the fact that the Commission - at least partially - was held responsible for illegally issuing a prohibition merger decision. For a long time, it was taboo to sue the Commission for misapplication of EU competition law. This changed in 2003, as both Schneider and MyTravel Group sued the Commission for compensation of damages.[236] In the Schneider/Legrand case the Commission was criticized by the CFI due to its fact-finding and resulting economic analysis. The Court stated that the Commission should have investigated the relevant markets more carefully. This case was examined under the original merger regulation, but it would also have raised competition concerns, at least in the French markets, if the fact-findings were done accurately. However, if Schneider was given more time to propose remedies to eliminate the competition concerns in the French markets, then it probably could have submitted more efficient

233 Case T-351/03, Schneider Electric SA v Comm'n, 2007 E.C.R. II-2237, point 260; D. Mykolaitis, *The Other Way Around: Liability of Community Institutions for Losses Incurred Due to Misapplications of EC Competition Law (Schneider III)*, 14 INT.TRADE L. REV. 3, 59 (2008) [hereinafter Mykolaitis].

234 Case C-440/07 P, Comm'n v Schneider Electric SA, 2009 E.C.R. I-6413, point 221.

235 *Id*. point 212.

236 Mykolaitis, *supra* note 233, at 52.

remedies. However, this judgment shows that Community Courts are able to provide efficient judicial review of merger decisions. Still, the judgment raised questions as to whether the Commission should keep its role as an investigator, prosecutor and judge.[237]

Nevertheless, one must not forget that the Commission's merger examinations in the overwhelming cases are satisfactorily evaluated, and most mergers get cleared.

In those cases where prohibition decisions are issued, the involved parties are entitled to appeal to the CFI for sophisticated review.

VII. Conclusion

This thesis tried to illustrate the legal framework for non-horizontal mergers. Unlike horizontal mergers, where guidelines were issued in 2004, this was not the case for non-horizontal merger guidelines. Such guidelines were not issued until 2007 with the objective to ease the application and interpretation of the EC merger regulation. The comments received on the public consultation process for drafting non-horizontal merger guidelines, showed that it was necessary to issue non-horizontal merger guidelines. It also speaks for itself that the United States has non-horizontal merger guidelines in place since 1984.[238]

In any case, such non-horizontal merger guidelines make it easier for firms to assess a potential merger, as they have clear guidance on what the Commission is likely to decide. This increases legal certainty and makes the Commission's decisions more easily predictable. Although such guidelines are not legally binding, like a directive or regulation, they are nevertheless self-binding for the European Commission. With regard to the content of the non-horizontal merger guidelines, these guidelines have been crucial for the Commission's

[237] Lang, *supra* note 227, at 259.

[238] *See* Dep't of Justice, USDOJ.gov, http://www.usdoj.gov/atr/public/guidelines/2614.htm.

practice on the assessment of non-horizontal mergers and the judgments by European Courts. The main concerns of the Court of First Instance in the GE/Honeywell and Schneider/Legrand cases were that the Commission did not carry out detailed economic analyses. These concerns were taken seriously in the newly issued non-horizontal merger guidelines. Indeed, these guidelines provide for a more economic-based approach in merger control proceedings. Today, it is clear that the Commission has done its homework with regard to the CFI's requirements for a more carefully rendered economic analysis. For instance, the TomTom/TeleAtlas case was decided and cleared under the new non-horizontal merger guidelines and included a careful economic analysis.[239]

With respect to content, these guidelines provide a “safe haven” for when the Commission will not oppose a concentration. For example, if the merged entity’s market share in all markets concerned will not exceed 30 percent after the merger, then the Commission will not find competition concerns. Another example would be the reference to the Herfindahl-Hirschman-Index, although this has triggered some criticism. Generally speaking, the Commission accepts that non-horizontal mergers are less likely to give rise to competition concerns than horizontal mergers. And those factors that can lead to competition concerns, like foreclosure, are illustrated in the non-horizontal merger guidelines. The fact that the Commission also takes efficiencies created by non-horizontal mergers into account made it necessary to demonstrate these efficiency-enhancing effects for both vertical and conglomerate mergers in separate chapters of this thesis. In practice, most mergers take place due to the increased efficiencies, like cost savings and better product quality, that firms expect the merger to generate. This also benefits consumers, which is the overall goal of the European competition policy. The Consumer welfare standard is today's European standard

[239] CRA International, *TomTom/TeleAtlas: The Non-Horizontal Merger Guidelines in Practise*, 30 EUR. COMP. L. REV. 1, 3 (2009).

for assessing potential concerns in merger control cases. Protecting competitors is not the main goal in EU merger policy; instead, protecting competitors is only a goal in such circumstances where negative effects on consumers are expected due to a lack of strong competitors. Conversely, if a merger is likely to benefit consumers, by such means as decreased prices or increased product quality, then it is accepted to have competitors driven out of the market.

The overall Commission's mindset toward merger policy is merger-friendly. Although the non-horizontal mergers that were forbidden raised particularly strong interest in the public, like the prohibited General Electric/Honeywell merger, one must bear in mind that these cases are the exception.

In sum, the Commission has made the right move in further developing merger policy by issuing these non-horizontal merger guidelines.

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