Efficiencies (and inefficiencies) in horizontal mergers

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Disclaimer: the views expressed are those of the speaker only and cannot be regarded as stating an official position of the European Commission

Outline

1. Review of recent cases
2. Economic and legal framework
3. Direct (static) claims
4. Indirect (dynamic) claims
5. Role of documentary evidence

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Overview of recent cases (since 2012)

Telecoms

1. H3G/O2 (Ireland), 2014
2. Telefonica/E-plus, 2014
3. Orange/Jazztel, 2015
4. TeliaSonera/Telenor, 2015*
5. H3G/O2 (UK), 2016
6. H3G/Wind, 2016

Non-Telecoms

1. DB/Euronext, 2012
2. Outokumpu/Inoxum, 2012
3. UPS/TNT, 2013
4. Nynas/Shell, 2013
5. Ineos/Solvay, 2014
6. GE/Alstom, 2015
7. Fedex/TNT, 2016

* Case withdrawn

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3. Direct (static) claims
4. Indirect (dynamic) claims
5. Quality claims
6. Role of documentary evidence

Economic framework

- A horizontal merger may reduce competition by **internalising a negative externality** between the merging parties
- But a merger could also **enhance competition** by bringing together **complementary assets**, thus leading to **lower costs** and/or **higher quality**
- Possible pro-competitive effects may offset the loss of competition between the merging parties (**balancing exercise**)
- Under existing merger practice, focus is on **consumer welfare**

Legal/policy framework

1 Verifiability

- **Reasonable certainty that efficiencies are likely to materialize**
- Quantification where reasonably possible
- A clearly identifiable positive impact if data not available

2 Benefit to consumers

- **Pass-on of efficiencies to consumers**
- Efficiencies must be timely
- Benefits to consumers in principle to occur in the same market as harm
- Cost-savings should not be result of anti-competitive output reduction

3 Merger specificity

- Efficiencies direct consequence of the merger
- **Cannot be achieved by less anti-competitive alternatives**

Efficiencies v. pro-competitive effects?

- Recurrent discussion on whether “pro-competitive” effects of a merger should be distinguished from efficiencies
- No logical distinction between pro-competitive effects and efficiencies
- Burden of proof differs between competitive assessment and efficiencies, but standard of proof should be similar (for like-for-like effects)
- *Deutsche Borse/Euronext*: Court accepts two-step approach
- *Nynas/Shell*: efficiency criteria integrated within competitive assessment

A simple taxonomy of efficiency claims

- **Direct/static claims**
  - Example 1: Marginal cost reductions from elimination of double marginalisation
- **Indirect/dynamic claims**
  - Example 2: Avoiding duplication of infrastructure leads to higher profitability and ultimately investment
  - Example 3: Use of scarce asset (e.g. 4G spectrum) across larger customer/asset base, lowering incremental investment costs
  - Example 4: knowledge spillovers in R&D

Need to take care to avoid double-counting

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Static (direct) claims: framework

- Economic mechanism grounded in standard logic of unilateral effects
  - If marginal costs fall after a merger, expanding output becomes more profitable
  - This can compensate (fully or partially) for upwards pricing pressure from reduction of competition
- Claim can be accommodated within well-established economic tools for unilateral effects
  - Apply consistent framework to harm and to efficiencies

Static claims: (successful) examples

- ***Nynas/Shell***
  - Replacement of high price US imports with (expanded) domestic production
  - Shown by using invoice and cost data, for same products
- ***GE/Alstom***
  - Lower input costs thanks due to greater buyer power for Alstom (Medium gas turbines)
  - Shown by relying on detailed study by external consultants
- ***Orange/Jazztel***
  - Elimination of double-marginalisation associated with Jazztel pre-merger MVNO contract

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Static claims: quantitative balancing

UPP (differentiated products)

Merger simulation can easily incorporate marginal cost reductions

Same assumption on pass-through applied to upwards and downwards pricing pressure

Can also compute *CMCR* (based on Werden)

But hard to fully offset price increases if margins are high

Examples: *Orange/Jazztel* and *H3G/Wind*

B/E (homogenous products)

"Bertrand-Edgeworth" modelling applied to industrial commodities (steel, S-PVC)

Market power effect from output consolidation can be partially offset by cost reductions

Modelling suited to balance two effects

Examples: *Outokumpu/Inoxum* and *Ineos/Solvay*

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Static claims: Verifiability

- Often one of key challenges with this claim
- Commission unlikely to accept vague or general claims ("management best estimates are that…" or "based on past experience we estimate that … ")
- On the other hand, showing cost benefits from in-sourcing or greater scale should be feasible if one has access to data from both merging parties

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Static claims: Marginal v Fixed Costs

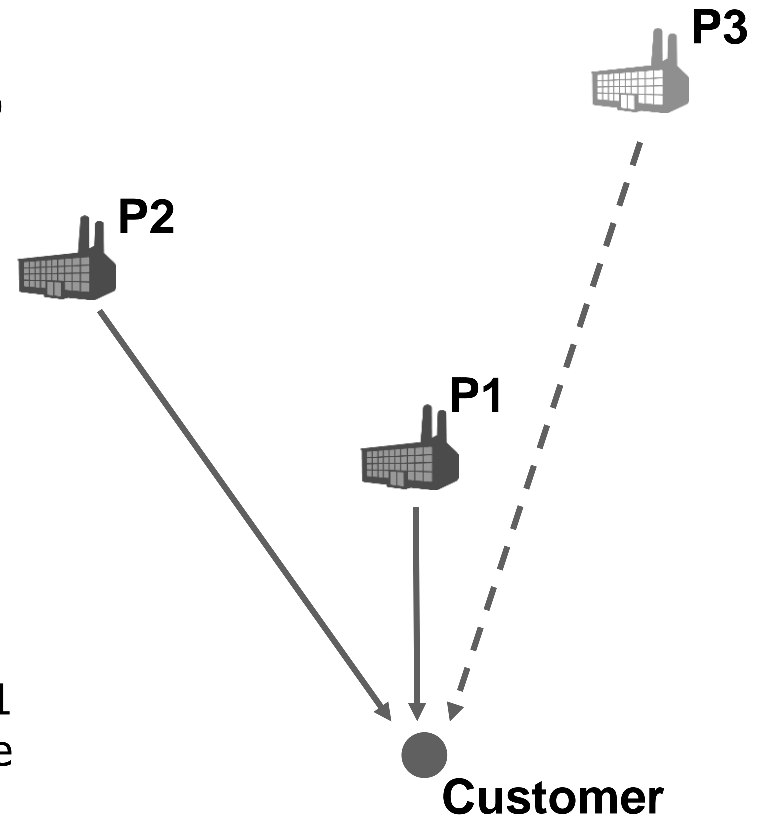
- Sometimes claim is made that variable costs will be reduced by merger, whilst in reality relevant costs appear to be fixed (in short/medium term)
- Need for consistency with overall claims:
  - if claim is that merger will **avoid costly duplication** of some activities, then those activities are likely to be associated with fixed costs (i.e. costs that can be avoided post-merger despite larger output of combined entity)
  - Similarly, if claim is made that one of merging parties is struggling to compete due to higher unit opex due to **lack of critical scale**, this also indicates that relevant cost base is largely fixed
- Commission has looked at internal documents on pricing to help determine this issue (e.g. *GE/Alstom*)

Static claims: Buyer power and remedies

- Economies of scale (e.g. from buyer power) can lead to lower input prices
- But what if the merger increases prices even after accounting for lower input prices?
- Any (structural) remedy designed to reduce consumer harm will also lower efficiencies ("vicious circle")
- Ultimately no account can be given to efficiencies from buyer power in this case
- Case study: *Ineos/Solvay*

Static claims: Farrell-Shapiro "no synergies" result

- Output reallocation from high-cost to low-cost assets should not qualify as an efficiency in a setting with homogenous goods (e.g. Cournot)
- Result carries over to settings with geographical differentiation
- Intuition:
  - merger removes the constraint on P1 from P2, reducing choice for user (P3 is farther away);
  - any output re-allocation from P2 to P1 cannot offset the increase in price due to the merger
- Case study: *Ineos/Solvay*



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Indirect claims: pricing

- Argument that firms take into account fixed cost savings in pricing decision is economically dubious
- "Marginal cost" pricing does not mean that firms price at marginal cost earning 0 profits!
  - it implies instead that pricing decisions react to changes in marginal cost, and that the presence of market power (e.g. due to barriers to entry) allows for enough rents to cover fixed costs
- Case study: *Telefonica/E-plus*
  - Parties argued that TEF followed a specific pricing model incorporating fixed costs; evidence rejected by Commission

Indirect claims: profitability and investment

- Fixed cost savings increase overall profitability of a firm, possibly affecting entry/exit decision
- But these savings do not increase the profitability of **marginal investment** opportunities
  - On the contrary, reduction in competition from a merger may reduce marginal profits from investment ("replacement effect")
- Economic literature on alleged ambiguous relationship between competition and investment (innovation) not directly applicable to merger control
  - Not a sound basis for an efficiency defence
- Case study: *TeliaSonera/Telenor*

Indirect claims: financial constraints

- Imperfect capital markets may mean that a firm faces a financial constraint, limiting its investment in profitable opportunities
- Internal capital markets may also lead to financial constraints
- Case study: *H3G/O2 Ireland*
  - Irish subsidiary of H3G claimed to be financially constrained pre-merger due to internal capital market
  - But H3G was the acquiring company in the deal: why would the parent Group allow the Irish subsidiary to retain higher profits from fixed cost synergies?
  - No concrete evidence on higher investment post-merger

Indirect claims: innovation spillovers

- In R&D-intensive industries, argument sometimes made that less competition may enhance innovation
- Absent spillovers, a merger is unlikely to increase innovation effort (the contrary is more likely – "dynamic inefficiency")
- However, if there are knowledge spillovers, a merger may increase appropriability and hence innovation (internalisation of a positive externality) – see section 10 of the US HMG
- Case study: *Dow/DuPont*
  - Parties did not claim efficiencies, but disputed the Commission's TOH on grounds that relationship between mergers and innovation is ambiguous

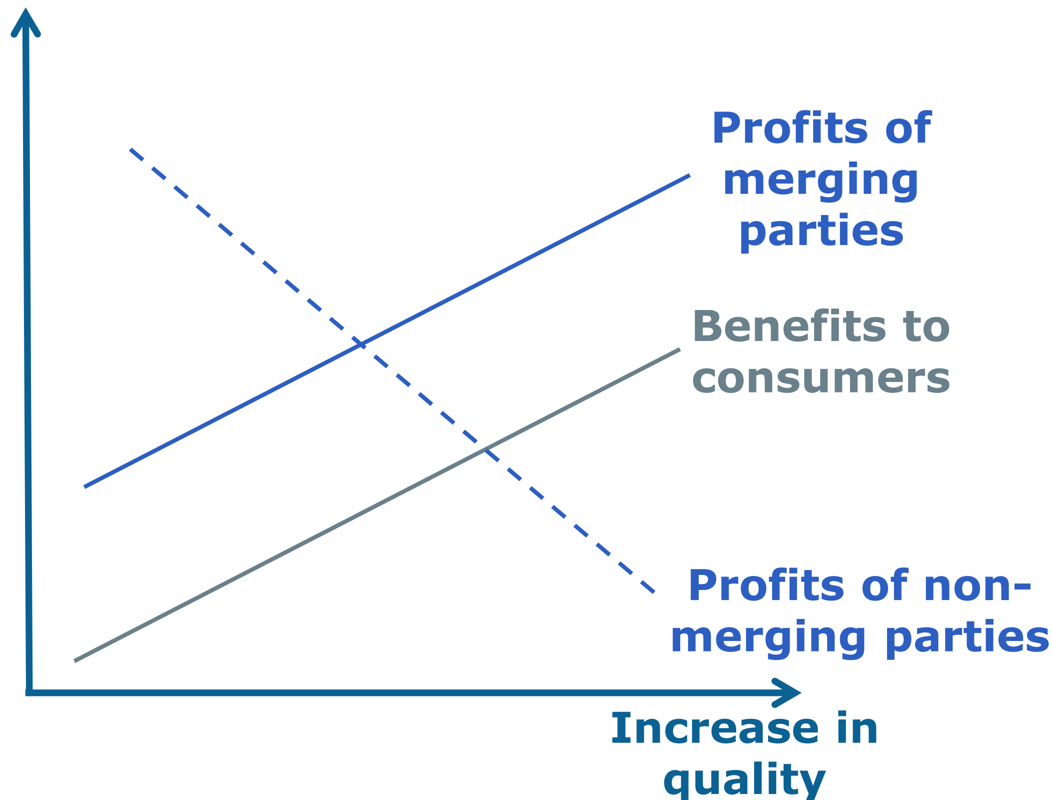
Indirect claims: quality improvements

- In some cases, the claim is made that a merger would lead to higher investment by avoiding duplication of infrastructure:
  - A scarce input can applied over a larger scale, leading to higher quality, e.g. access to more LTE spectrum in mobile telephony resulting in higher coverage/speed
  - Network investment more profitable due to economies of density (e.g. fibre footprint)
  - Process innovation applied on larger scale
- Improvements in quality can benefit consumers
  - Higher quality can offset an increase in price resulting in a **reduction in quality-adjusted prices**
  - Partial claw-back of benefits by merged entity needs to be accounted for (*Deutsche Borse/Euronext*)

Quality claims: merger-specificity

- In recent cases (most notably mobile mergers) the main challenge for quality claims has been **merger-specificity**
- Are there **commercially viable** and **less restrictive** alternatives to reach **similar** quality improvement?
- **Network sharing** example
  - Allows MNOs to share active equipment and/or spectrum
  - Lowers incremental costs of network capacity, allowing MNOs to reach higher coverage/speed
  - Common business practice in Europe, delivering apparently competitive outcomes
  - Actively considered by merging parties in recent cases (*Telefonica/E-plus*; *H3G/Wind*)

Quality claims: commercial viability v. benefits to consumers



- There is typically a positive correlation between benefits to consumers and benefits to the merging parties resulting from a quality improvement
- This implies that there can be tension between a claim of high benefits to consumers and a claim of merger-specificity

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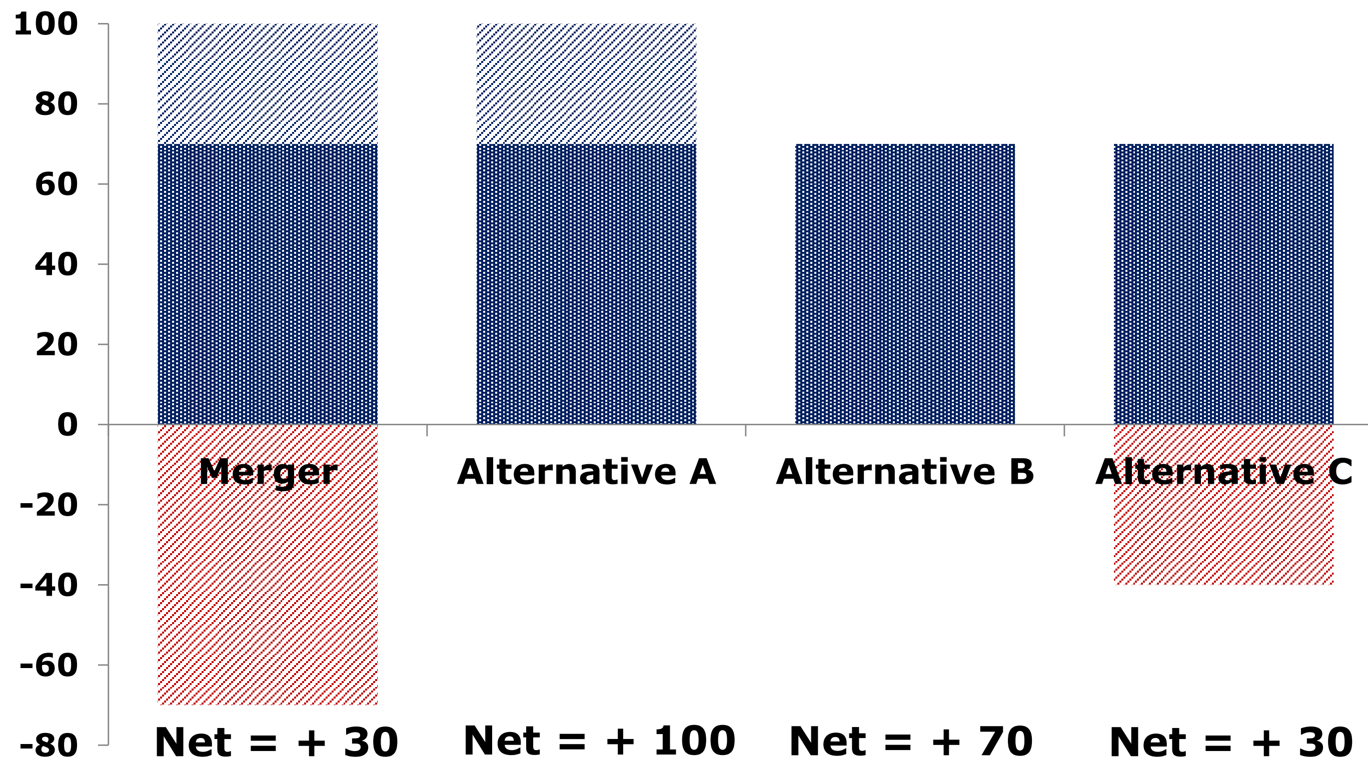
Quality claims: "same" v. "similar" efficiencies



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Consistency of evidence: sources

- Synergy estimates may be initially prepared directly by the business – this can give insights on deal rationale
- Detailed synergy computations often prepared by external strategy consultants
  - Typically not prepared in accordance with HMG (synergies ≠ efficiencies)
  - But may still be influenced by competition risk considerations (e.g. focus on cost rather than revenue synergies)
- Important to identify evidence from "*tempore non suspecto*"

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Consistency of evidence: role of third parties

- A plausible efficiency claim is typically associated with a positive impact on the profits of the merging parties, and a negative impact on profits of non-merging parties
- Hence it can be difficult to square a credible efficiency claim with evidence that non-merging parties benefit from merger and/or explicitly welcome it
  - *TeliaSonera/Telenor*: stock price of TDC rose on merger announcement, and fell on withdrawal
  - *Orange/Jazztel*: main incumbent (Telefonica) supported consolidation in Spain
- May suggest that efficiency claim is weak or that harm to competition is under-estimated (e.g. coordinated effects?)

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Case study: Public statements of competitors in H3G/Wind

TIM

"*We continue to believe that the **most effective way to stabilize our mobile market is through a reduction in the number of players**. We will continue to pursue any concrete opportunity that should become available on that front*" (2013)

"*The **better combination is the one that ends with a more symmetric position among the remaining three players**. It's natural that if this move materialize we could be available to help the deal to happen*" (2013)

"*We're more than favorable to any consolidation given the fact that **we can help the consolidation to happen** … So if it happens we will be there*" (2014)

"*I have a couple of **good bottles of champagne in my refrigerator in just in case***" (2015)

Vodafone

"*Would you be willing to facilitate consolidation in Italy? … would you help facilitate that in terms of buying spectrum, buying towers and things like that?" "The answer is **rationally and at the right price levels, yes***". (2014)

"***We would clearly do everything to have a better industry structure there** … **When contributions or roles will be needed, we'll be there** … It's important that Italy gets a better industry structure and we would be willing to look into that*" (2014)

"***Consolidation is good if it happens with the right conditions**. It's bad if it happens with the wrong conditions*" (2015)

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Conclusions

- The Commission's efficiencies policy seeks to strike a balance between accepting valid claims and rejecting claims where benefits to consumers due to merger are unlikely
- Static efficiencies easier to verify and hence more likely to be accepted
- In recent cases efficiencies more often submitted, assessed and also accepted

For more details see: Buehler & Federico, "Recent Developments in the Assessment of Efficiencies of EU Mergers", 2016, *Competition Law & Policy Debate*, 2(1), p. 50-61