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Economic analysis of unilateral effects

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Analytical framework

Unilateral effects

- Horizontal
- Vertical
- Conglomerate

Horizontal Unilateral Effects

Legal test
Elimination of important competitive constraints (ICC)
(not only dominance)

Pre-merger

If the acquiror raises prices, it would lose at least some of its sales to the target

Post merger

The acquiror would no longer be constrained by the target (i.e., it would re-capture the sales that pre-merger it would have lost to the target)

Non-merging firms could also benefit from the merger

Factors to be considered

- Market shares
- Closeness of competition
- Customers' ability to switch
- Competitors' ability to expand output
- Merged entity's ability to hinder competitors' expansion
- Important competitive force

Not exhaustive list

Not all elements need to be present

Market shares & concentration levels

- **First** useful **indication** of market structure and competitive strength of various players
- **Market shares**

Dominance cases	"Gap cases"		Presumption of no problem (rebuttable)
50% or more: presumption of dominance (rebuttable)	Between 40 and 50%: potentially problematic	Below 40%: typically less problematic but no safe harbour	Below 25%: typically no problem

- **Concentration levels**
  - HHI index

Closeness of competition

The higher the degree of substitutability between the merging firms' products, the more likely it is that the merging firms will raise prices significantly

Key points

Homogeneous vs **differentiated** product markets

Relative approach, not binary exercise: the merging firms need not be one another's closest competitors (or closer competitors to one another than their market shares would suggest)

Investigative tools

Qualitative: internal documents

Quantitative: customer surveys, analysis of purchasing patterns, estimation of the cross-price elasticities of the products involved, diversion ratios

Hutchison 3G UK / Telefonica UK

Merger eliminates competition between Three & O2, which are close competitors in the retail market

Evidence

Qualitative: market investigation, internal documents

Quantitative: diversion ratio

Facebook / WhatsApp

Merger eliminates competition between Facebook & WhatsApp, which are NOT close competitors in the market for consumer communication apps

Evidence

Qualitative: product differences which limit substitutability, "multi-homing" suggest complementarity

Important competitive force (ICF)

Legal test
Firms having more of an influence on the competitive process than their market shares or similar measures would suggest
(not only "maverick")

Examples

Recent entrant

Innovation

Investigative tools

Qualitative: history, offering analysis, internal documents

Quantitative: gross adds, pricing analysis

Hutchison 3G UK / Telefonica UK

Merger eliminates competition between Three & O2, which are important competitors in the retail market

Three – ICF or in any event ICC

- History of a classic maverick and most innovative player
- Lowest prices in direct channel and strong gross adds
- Most reliable network and good network quality
- Profitable business today & going forward
- No capacity constraints in near future

O2 - ICC

- Market leader by subscribers
- Competitive offers also through giffgaff & Tesco Mobile
- Best brand and customer loyalty
- Profitable business today & going forward
- Ability to compete unlikely to be materially impacted by capacity constraints

Economic tools

1. Economic tools in merger control

The classical analysis (I)

1. Defining the relevant market
2. Assessment based on market shares and market concentration (HHI)
   - » "Safe harbour" HHI thresholds (the European Commission)
     - » HHI < 1.000
     - » 1.000 < HHI < 2.000, delta < 250
     - » HHI > 2.000, delta < 150

- » Assumption: Market shares measure competitive pressure
- » Change in market shares/HHI = "unilateral effects":
  - » Large change in HHI = Indication of sign. weakening of competition

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The classical analysis (II): Imaginary Example

NB! Market shares do not tell us whether the parties are actually close competitors when products are differentiated

DANISH COMPETITION AND CONSUMER AUTHORITY

The new economic tools (I)

» Focuses on how a merger changes the pricing incentives:
  » Before merger: Profit maximizing on the basis of own products
  » After merger: Profit max. on the basis of own and acquired products

» Effects of the merger:
  1. Incentive to increase prices due to decreased competitive pressure
  2. Incentive to lower prices due to merger specific efficiencies

» **UPP** (Upward Pricing Pressure)
- Direction of the price change

» **IPR** (Illustrative Price Rise)
- Estimate of the exp. price change

Based on:
» Diversion ratios
  » Closeness of competition
» Margins
» Relative prices
» Merger specific efficiencies

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The new economic tools (II)

» Direct focus on the competitive pressure eliminated due to the merger

» Simple and intuitive method compared to merger simulation models:

  » Easy to communicate to non-economists

  » Possible to do within the time limits of a merger review

» Differs from the classical analysis based on market definition and a subsequent assessment based on market shares and the degree of market concentration

» Supplement to the overall assessment:

  » For instance, dynamic responses are not taken into account

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Diversion ratios (I)

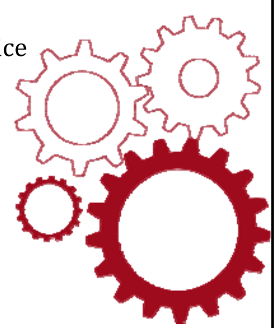
» Closeness of competition between the merging parties

» Indicates the degree of competition lost due to the merger

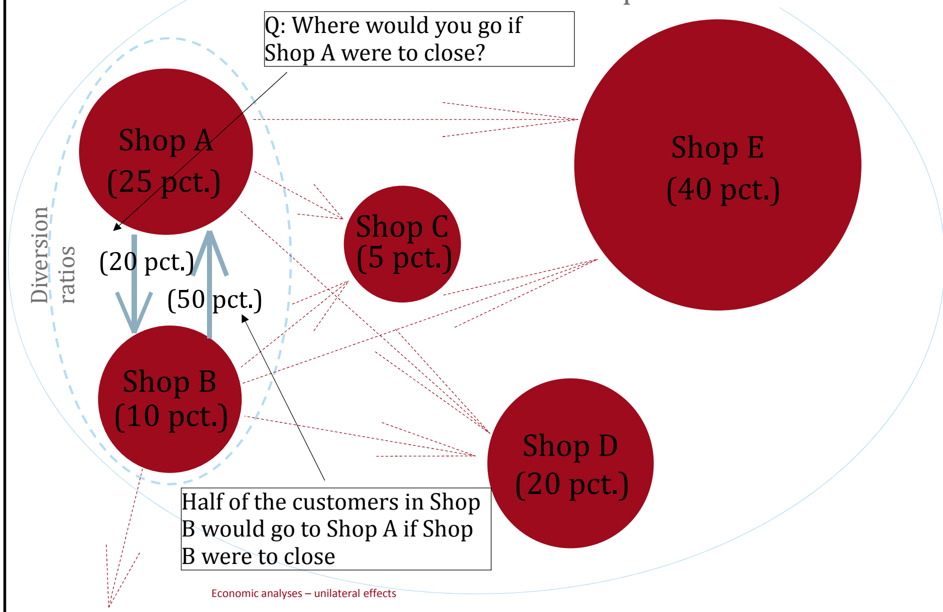
» How large a share of the customers lost in case of a price increase are lost to the other merging party?

$$D_{\mathrm{A,B}} = -\frac{\delta q_{\mathrm{B}}/\delta p_{\mathrm{A}}}{\delta q_{\mathrm{A}}/\delta p_{\mathrm{A}}}$$

» A number between 0 (not close competitors) and 1 (close competitors)



Diversion ratios – a basic example



3. The merger between Arcus and Pernod Ricard

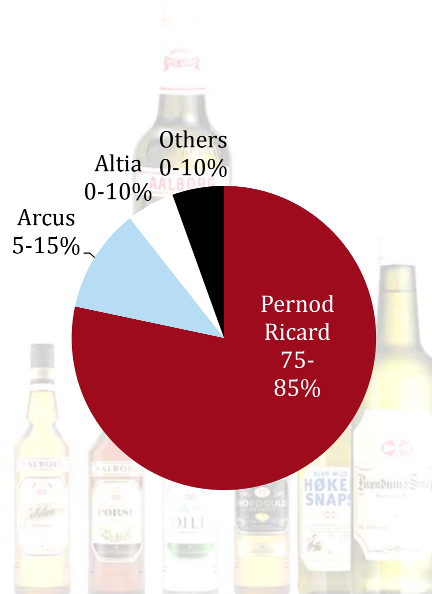
The transaction

- On 31 July 2012, Arcus notified the acquisition of:
  - Pernod Ricard's Danish aquavit brands
  - Gammel Dansk
- **Arcus:** Norwegian alcohol producer. Sells Linie Aquavit in Denmark
- **Pernod Ricard:**
  Second largest alcohol producer worldwide

  Leading producer in Denmark: Rød Aalborg, Brøndums, Gammel Dansk m.v. + Malteserkreuz in Germany

Market shares

- Significant increase in the concentration level
- The counterfactual was status quo
- Relevant to further investigate the risk of unilateral effects

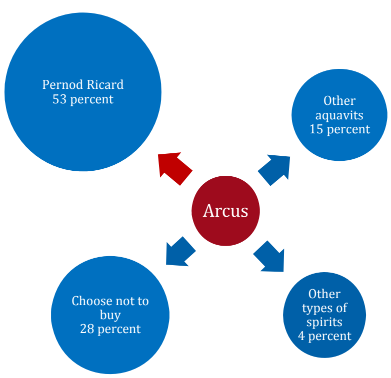


Diversion ratios – consumer survey

- 1.007 respondents that bought an aquavit within the last year
- Asked what aquavit they bought last time – and what they would have bought if this aquavit had been sold out
- Used in assessment of unilateral effects, in market definition and in the assessment of remedies

Diversion Ratios

Figure 5: Diversion ration from Arcus to Pernod Ricard Denmark



IPR: How will Arcus set prices after the merger?

Diversion ratio
D=53 pct.

Profit
M=XX pct.

Efficiencies

$$IPR = \frac{DM}{2(1-D)} - \frac{E(1-M)}{2}$$

IPR=3-5 pct. (8-12 % with isoelastic demand curve)

Remedy

- Divestment of Brøndums
- HHI decreased
- Diversion ratios:
  - Brøndum is a strong brand

Break ☺

Efficiencies

General principle

Balancing exercise
Do efficiencies counter-act possible adverse effects on competition?

Mergers may **enhance** the ability and incentives of the combined entity to **behave pro-competitively**

Put forward by the parties, Commission assess

Right of defense

Cumulative conditions

- **Consumer benefits**
- **Merger-specificity**
- **Verifiability**

Consumer benefits

- **Pass-on** of efficiencies to consumers
  - Reductions in variable or marginal costs (as opposed to fixed costs) more likely to be passed on and result in lower prices
  - Pass-on related to competitive pressure from remaining players/entry (less likely for monopoly)
- Efficiencies must be **timely** (the later, the less weight)
- Benefits to consumers should occur on the **same market as the harm**
- **Challenges**: quantification/order of magnitude, timeliness and likelihood

Merger specificity

- Efficiencies as **direct consequence** of the merger
- Efficiencies cannot be achieved to a similar extent by **less anti-competitive alternatives**
  - Alternatives reasonably practical in the business situation (eg. JV, production agreements)

Verifiability

- Reasonable certainty that efficiencies are **likely to materialize** and **substantial enough** to counteract harm
  - **Quantification** where reasonably possible, or
  - If data not available, a **clearly identifiable** positive impact, not a marginal one (=**substantial**)
- **No prescribed pieces of evidence**
  - Pre-merger internal documents or studies independently verified by a third party not required

Deutsche Boerse / NYSE-Euronext

The merger would have created a near monopoly in European financial derivatives

Parties

Collateral savings (EUR 3 billion): combination of parties' margin pools. Arise automatically on the side of customers and therefore no need for "pass on"

Liquidity benefits: through the reduction of bid-ask spread

IT savings: through the combination of networks

Commission

Conditions not met, but for collateral savings

- **Verifiable**, but the actual cost savings would be EUR 155 million
- **Merger Specific**
- **Passed-on**: savings accrue on customer side, yet limited because of claw-back (price response to cost savings)

In any event **not enough to outweigh the harm**

Hutchison 3G UK / Telefonica UK

The merger reduced competition in the market, hampered the development of the UK mobile network infrastructure as well as the ability of mobile virtual operators to compete

Parties

Absent merger, parties face:

Incremental costs of capacity expansions (invest to keep up with demand)

Additional "costs" of progressive network congestion (quality decrease despite investment)

Post-merger

Increased market power (↑ price)

Network consolidation eliminates network costs (↓ price)

→ **Net effect**: ↓ price

Commission

Merged entity can deploy the joint spectrum on a denser network

→ Some incremental network cost reductions conceivable

However, configuration of final consolidation plan was unclear

Conclusion

Efficiencies are possible but not verified and in any event unlikely to offset the price effects

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Case study
Comparing experiences of EU and MOFCOM review of the ABBOTT LABORATORIES / ST JUDE MEDICAL merger case

Eleonora Ocello (DG COMP, European Commission)

European Commission review

In a nutshell

Phase I clearance subject to remedies

Substance

Acquisition of St Jude Medical Inc. by Abbott Laboratories

Largely complementary businesses but

- Horizontal overlaps in **cardiovascular products**
- Possible conglomerate links

Procedure

03.10.16 - Notification

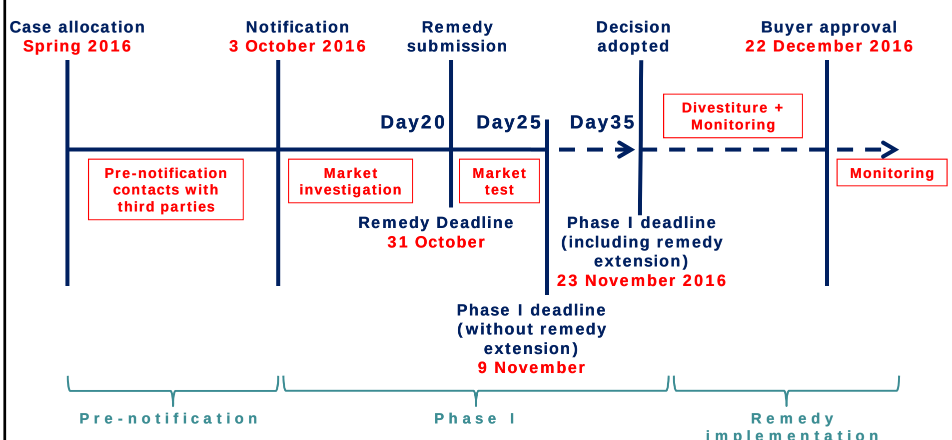
23.11.16 - Decision adopted

22.12.16 - Buyer approval

Other jurisdictions

- US FTC
- Canadian CB
- South Africa CC
- Brazilian CADE
- MOFCOM

Procedure in detail



Horizontal Unilateral Effects (1)

Vessel closure devices (VCDs)
Market-to-market overlap

Market definition

Segmentation small-hole vs large-hole VCDs left open – **St Jude does not offer large-hole VCDs**

Excluding manual compression, closure assistance devices and surgical suturing

National scope

Competitive assessment

High market shares:

[50-60]% EEA and >40% in 23 countries

>40% in 21 countries for small-hole VCDs only

Parties are close competitors

Concerns raised by doctors

→ **SERIOUS DOUBTS**

Horizontal Unilateral Effects (2)

Transseptal sheaths
Market-to-pipeline overlap

Market definition

Segmentation steerable and flexible left open – **Abbott has only a pipeline steerable product in the EEA**

Segmentation by size left open

National scope

Competitive assessment

St Jude has very **high market shares**

Abbott **could** become close competitor and **exert significant pressure**

Unlikely alternative entry

→ **SERIOUS DOUBTS**

Horizontal Unilateral Effects (3)

Structural heart
Pipeline-to-pipeline overlap

Market definition

Devices for treatment of different medical conditions constitutes a separate market – in particular **transcatheter mitral valve (TMV)**

Segmentation repair vs replacement (TMVR) left open

EEA scope

Competitive assessment

Both parties are developing TMVR, St Jude is at much earlier stage of development

Parties are **not close competitors**

Many other **alternative** products being developed and at more advance stage

Only **conglomerate** concerns raised voiced

Conglomerate Unilateral Effects

Large-hole VCDs and other cardiovascular devices

Leveraging Abbott's strong position in large-hole VCDs via bundling

Lack of ability to foreclose

No issue of technical compatibility

No commercial link

Customer multi-sourcing

VCDs no driver of customer/doctor choice

Lack of incentives to foreclose

No impact on competition

Reaction of competitors

Coronary imaging & coronary interventional devices

Leveraging St Jude's strong position in imaging via bundling

Lack of ability to foreclose

No issue of technical compatibility

No commercial link

Customer multi-sourcing

Lack of incentives to foreclose

No impact on competition

Reaction of competitors

Commitments

Structural divestment

Description

St Jude's VCD business

Part of production facility

Manufacturing equipment

Personnel, IPRs, customer records

Abbott's transseptal sheath business

Shareholding in developer company

Transitional agreement

Assessment

Complete removal of the overlap

Include all relevant assets

Positive market test

Purchaser criteria ensure sale to suitable purchaser which will preserve competition

Buyer identified already during the procedure, but not fix-it-first