

# Substantive economic analysis in merger control



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This Quickguide considers the approach taken by competition authorities to the review of mergers, using a blend of legal and economic analysis. In particular, the guide considers the following topics and explains the way in which economic principles will be applied to the facts of a particular case:

- The broad categories of mergers
- Market definition and the significance of market shares
- Barriers to entry and expansion
- Countervailing buyer power
- The counterfactual to the proposed merger
- Specific issues arising for particular types of mergers

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## 1. Introduction

The objective of merger control globally is to prevent the adverse effects which may arise from anti-competitive mergers, which ultimately deprive consumers of the benefits of competition. Economic analysis – supported by robust and technical evidence – is at the heart of the assessment of mergers, and all leading competition authorities field integrated teams of economists and lawyers to assess competitive effects.

An apparent obstacle to any general overview of merger control is that different jurisdictions apply different legal tests and procedures for assessing mergers (e.g. in the UK, the US and Australia, the test is whether the merger may be expected to give rise to a substantial lessening of competition, while the European Commission considers whether the merger in question can be expected to give rise to a significant impediment to effective competition, and in Germany the test is whether the merger will create or strengthen a dominant position). In addition, some merger control regimes accept efficiency, failing firm and other defences to otherwise anti-competitive mergers.

However, whilst due account should be taken of such differences, they should not be overstated. Since substantive merger assessment is typically based on widely accepted economic principles, there are strong commonalities in the economic assessment across jurisdictions, with the key focus ultimately being whether the merger is likely to give rise to market power and anti-competitive effects.

## 2. Defining the issues

### Type/category of merger

The first stage of any competition assessment is to define the types of issues which need to be considered. These issues may be categorised according to the nature of the merger in question (although a particular merger may, of course, fall into more than one category).

- **Horizontal mergers** are mergers between actual or potential competitors which operate at the same level of the supply chain (such as manufacturing or retailing), and typically involve firms that compete in the production or sale of substitutable goods or services. The vast majority of mergers that give rise to competition concerns are horizontal mergers as they typically remove a competitor from the market.
- **Vertical mergers** are mergers between firms involved at different levels of the supply chain (for example, mergers between raw material suppliers and manufacturers, or between wholesalers and retailers). One key concern with such mergers is the threat of foreclosure, whereby the merged firm may be able to deny its competitors access to essential upstream inputs (such as raw materials) or to key downstream customers/markets.
- **Conglomerate mergers** may be defined as mergers between firms active in different, but related markets, such as those between suppliers of complementary products (i.e. products that are often purchased or sold together). In particular, the merged entity may be able to acquire or increase its market power by offering common customers a "bundle" of goods or services which rivals cannot match. However, conglomerate mergers are generally much less likely to give rise to competition concerns than horizontal or vertical mergers.

### Past cases

Although each merger is looked at on its facts, a useful starting point for assessing the likely attitude of the competition authorities to a merger is to look at previous decisions in similar markets or where similar issues have arisen. This is likely to be particularly influential in first stage investigations as it

provides an obvious comparison against which the merger can be assessed. However, as emphasised below, such "precedents" should be used only as a guide – the facts or issues at stake will vary between cases. The competition authorities may be reluctant to place much weight on previous decisions which are relatively old, or in markets which have been subject to innovation or technological change.

## Internal documents

Useful information may be obtained from the parties' internal documents or market research undertaken by the parties which comment on the state of competition in the market pre-merger, the rationale for the merger, the competitive effects of the merger, and the competitive constraints the merged business may face post-merger. Internal documents may be particularly revealing if they set out the views of the senior managers of the business, and are commonly requested by competition authorities in both first stage and second stage cases.

Documents which refer to the parties as being close competitors or predict that the merger would increase prices (or reduce other non-price parameters of competition) are commonly referred to as "hot" documents, and such evidence is often given substantial weight by the relevant competition authority, particularly in first phase investigations. Information contained in internal documents and market research reports can also be particularly influential in merger cases when supported by the other qualitative and quantitative evidence available.

## Third party complaints

A further key factor in how a merger will be viewed by competition authorities is the extent to which third parties submit credible complaints about the proposed merger. Greater weight is typically given to customers' complaints on the grounds that competitors' interests may not be closely aligned with those of consumers (i.e. competitors are less likely to complain about anti-competitive mergers that result in higher prices). Accordingly, close attention to customer relations may be particularly important for firms when a merger is being contemplated as strong customer complaints are likely to have a significant bearing on the relevant competition authorities' decision.

# 3. Market definition

Before considering whether a merger raises substantive issues it is necessary to consider the various competitive constraints which the merged business will face. The starting point in the examination of competitive constraints is typically to define the scope of the relevant economic market(s) within which the parties compete. Market definition has two basic dimensions: products (or services) and geographic scope. Markets may also be defined by reference to customer group or temporal factors.

Many competition authorities worldwide, including the European Commission, the US Department of Justice (DoJ) and Fair Trade Commission (FTC), the Australian Competition and Consumer Commission (ACCC), and the UK's Competition and Markets Authority (CMA), define markets by reference to the so called "hypothetical monopolist" or "SSNIP" test. The test starts from the narrowest plausible candidate market and asks how customers and suppliers would behave in response to a "small but significant non-transitory increase in price" (which is usually assumed to involve a price increase of 5-10 per cent), assuming the price of all other products remain the same.

If customers are sufficiently price sensitive that a sufficient proportion would switch to alternative products (demand-side substitution) to render the price increase unprofitable, then the product market is wider than that being considered. Similarly, if a sufficient number of suppliers diversify into supplying the relevant products or services in question (supply-side substitution), this also indicates a broader product market definition. A similar approach considering both demand-side and supply-side substitution is also applied in assessing the scope of the geographic market.<sup>1</sup> A relevant market

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<sup>1</sup> In mergers involving local markets, competition authorities often define the scope of the geographic market by reference to the area from which the parties draw a significant proportion of their customers (with the CMA often focussing on the closest 80 per cent of the parties customers).

comprises those products and geographic areas in which such a price increase by a hypothetical monopolist would be profitable.

It is important to note, however, that market definition should not be considered to be an end in itself. It merely provides a framework for analysing the competitive pressures faced by the merged entity. In other words, just because a market has been defined in a particular way, it does not mean that competitive constraints do not apply from outside the market or that all competitors within the market are equally close rivals, particularly where the products are highly differentiated.

## Testing for market definition

As indicated above, past cases may be informative as to the scope of the relevant market. The CMA's guidelines note that in defining markets, where appropriate, the CMA will have regard to previous decisions of the CMA (and its predecessors, the Office of Fair Trading and the Competition Commission), the European Commission and other competition authorities that concern the scope of the market(s) at issue. What makes such "precedents" persuasive is the economic evidence they contain and their relevance to the case in question. However, a past case may not be particularly informative if the market has changed significantly (e.g. due to innovation) since the previous decision.

As stated above, market analysis is always driven by the facts of the particular case under consideration. A range of factual and empirical evidence may be relevant to testing for market definition, including:

- **Information on relative prices, qualities and functions of various products.** Comparisons of the attributes of different products and services can be used to identify quickly on a "common sense" basis which goods and services compete. However, such comparisons of attributes and prices reveal nothing about the extent of substitution which would occur in response to relative changes in prices, which is the relevant question in relation to the correct application of the SSNIP test.
- **Price correlations.** Trends (correlations) in transaction prices over time may be informative as to demand and supply-side substitutability. If goods or services are close competitors, or there is competition from different geographic areas, their prices should be expected to move in line over time; if there is divergence in their prices, any such divergence should be short-lived. However, there are limitations with such price correlation analysis. For example, there is no minimum threshold of price correlation required for products to be deemed to be "in" the same market, and spurious price correlations may arise for a number of reasons.<sup>2</sup>
- **Information on how firms set (and change) prices.** This may be informative in understanding the constraints considered by the business in setting prices, and how they respond to their rivals. Information on price setting can often be obtained from the parties' internal documents or from discussion with the appropriate business managers.
- **Behaviour of customers and suppliers to shocks.** The scope of the market may also be revealed by suppliers' and customers' behaviour following significant changes in the relative prices or quality of products, or other so-called "market shocks". If products compete in the same market and their prices diverge or they face a supply shock, such as a temporary store or factory closure, then substantial switching between the products should (absent other plausible explanations) be observed.
- **Evidence of customer switching.** In addition to providing examples of customers switching between suppliers, information may be collated on any costs which customers incur in switching products or suppliers (e.g. due to the costs of adjusting machinery to process a different product, learning how to use a new technology or testing that a new product is fit for purpose). Material switching costs can reduce the willingness of customers to switch between suppliers which in turn may affect the relevant market definition.

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<sup>2</sup> For example, different product prices may be subject to trends or common influences (e.g. due to common raw material/input costs, inflation or exchange rate movements). Similarly, changes in product qualities may make meaningful price comparisons very difficult to determine.

- **Customer surveys.** Surveys provide a means to understand customer purchasing decisions and factors that influence customer choices. They can also be used to assess how consumers would react to hypothetical events (such as a 5-10 per cent price increase, or a temporary store closure) which enables the hypothetical monopolist test to be tested directly, and can be used to assess the closeness of competition between different firms in the market.
- **Critical loss analysis.** This involves estimating the volumes of sales that would need to be lost to render a hypothetical price increase unprofitable. If the actual loss in sales (e.g. in response to market shocks, or actual price increases) is less than the critical loss, then it shows that the market is no wider than that being considered.

Whilst many of the techniques set out above are relevant to the assessment of market definition, they also provide insight into the closeness of competition between suppliers, which is at the heart of the substantive competition assessment (as discussed further below).

## 4. Market shares

Once the relevant market has been defined the market shares of the parties can be calculated. Market shares and measures of market concentration are frequently used as a *prima facie* indicator of market power.<sup>3</sup> As a very general rule of thumb, the higher the market share of the merged undertaking, the greater the increment in its market share, and the fewer the number of significant competitors which remain, the more substantive economic evidence the competition authorities will require to conclude that the merger is not anticompetitive.<sup>4</sup>

Historic market shares may also provide a useful insight into the competitive dynamics of the market. For example, changes in market shares over time (i.e. the last three to five years) might suggest that there is effective competition in the market as there is evidence of customers being won and lost, whereas small changes in market share over time may highlight a lack of effective competition. Snapshots of market shares do not reveal the dynamic nature of competition taking place in the market, particularly in "lumpy" markets with large, infrequent awards of major contracts. Authorities will also wish to have regard to expected developments which may impact on firms' market shares such as imminent new entry or expansion/contraction (e.g. due to the development of a new product, the success or failure to develop a new technology and so on).

Given the difficulties in accurately defining markets, it is common for competition authorities not to reach a definitive view on the scope of the relevant market in first stage inquiries, but to consider whether concerns would arise if different definitions were to be adopted. In these circumstances, the parties' arguments in favour of the merger should not rest solely on the simple line of defence that the merged company would hold a relatively low share of a more widely defined market, but should also emphasise the strength of the remaining competitors even if a narrow market definition were to be adopted.

## 5. Barriers to entry and expansion

It is generally recognised that low barriers to entry and expansion prevent the existence of significant market power on the basis that any anti-competitive price increase (or any other failure to meet customers' requirements) will either prompt new competitors to enter the market, or existing competitors to expand their business, and thus prevent the price increase being profitable. Competition authorities will typically assess this issue with regard to three broad factors, namely whether new entry and expansion:

- is likely on normal commercial terms;

<sup>3</sup> A commonly used measure of market concentration is the Herfindahl-Hirschman Index (HHI). The HHI is calculated by summing the squares of the market shares of all of the firms within the market. Reliance on HHIs implicitly treats a lower HHI as indicative of a more competitive market structure than a higher HHI.

<sup>4</sup> There is generally no particular market share (or increment in market share) threshold which automatically points to competition concerns being identified.

- would be timely (e.g. within two years), reflecting the fact that it may take time for new entrants or small firms to establish themselves as significant rivals; and
- would be sufficient to constrain any attempt to exploit market power, with small scale or niche entry potentially not achieving this.

Competition authorities will tend to consider that barriers to entry and expansion are low if the following factors are present:

- the sunk or irrecoverable costs of entering the market are low relative to total market sales (and the revenue and profits achievable from entry). High sunk entry costs may deter new entry by making it a risky proposition, because such costs cannot be recovered should entry subsequently prove unsuccessful;
- entry can be viably accomplished on a small scale. Entry will tend to be easier and less risky if prospective entrants need to win only a low market share in order to be viable;
- entry is not prohibited by legal barriers to entry such as regulation (e.g. environmental controls), restrictive licensing laws, or patents and intellectual property rights; and
- if there has been successful new entry in recent years, or small competitors have been able to expand and win market share from their larger rivals.

In assessing barriers to entry and expansion, case studies of recent capacity additions and entry may provide an indication of entry difficulty, costs and risks, the feasible scale of entry (e.g. the size of an efficient plant relative to market size), how new products are marketed and distributed and so on. Obviously, evidence of actual new entry and large existing suppliers losing market share to new or small suppliers will be helpful. However, it should also be noted that the absence of new entry or expansion may equally reflect the intensity of existing competition, rather than any substantive barriers to entry or expansion.

## 6. Countervailing buyer power

A further potential constraint on the market power of the merged entity may arise from the exercise of countervailing buyer power by the merged entity's customers. Countervailing buyer power is defined, for example, by the European Commission as "the bargaining strength that the buyer has vis-à-vis the seller in commercial negotiations due to its size, its commercial significance to the seller and its ability to switch to alternative suppliers".<sup>5</sup>

A natural structure for assessing buyer power is to assess buyers' ability and incentives to influence the terms of supply by purchasing less (or potentially nothing) from the supplier(s) in question (i.e. buyer dependency), and the consequences to suppliers of a reduction in sales to those particular buyers (i.e. supplier dependency). This will depend upon the ability and incentives of buyers to:

- reduce, or credibly threaten to reduce, their purchases from the merged entity by switching, or credibly threatening to switch, some or all of their purchases to rivals;
- increase the effort and sophistication of their procurement processes or change the "rules of the game" (e.g. by threatening to re-tender contracts or to de-list products to extract lower prices, investing time and effort to identify and develop alternative sources of supply, etc.). This will need to be judged by reference to how effective procurement arrangements are in practice;
- threaten to enter the market themselves, sell more own-label products, or sponsor entry by others (such as by offering a new entrant a long-term contract); and/or
- otherwise impose costs on the supplier even where buyers have no choice but to take the supplier's products (e.g. the buyer could refuse to buy other products produced by the supplier, delay purchases, or position the supplier's products in less favourable parts of the shop).

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<sup>5</sup> Paragraph 64. European Commission Notice: Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings. OJ (2004) C31/3.



An obvious starting point in assessing countervailing buyer power is to consider how customers currently procure products and how they seek to secure competitive terms. Regardless of buyers' commercial importance to suppliers, if they cannot exert influence over a supplier by credibly threatening to reduce significantly their purchases or otherwise impose costs on suppliers, such buyers may not have countervailing buyer power. Clearly, a merger that significantly reduces the switching options for customers may also have an impact on their buyer power post-merger.

## 7. The counterfactual to the proposed merger

In assessing whether a merger is likely to give rise to anti-competitive effects, a key issue considered by the relevant competition authority is what would have happened in the absence of the merger (i.e. the counterfactual to the merger). For example:

- Would one of the parties to the merger and its relevant assets otherwise have exited the market<sup>6</sup>?
- Was one of the parties the most likely potential entrant to the markets in question?
- Were there other market developments likely to impact the relative competitiveness of the parties and their rivals?
- If the merger in question had not taken place, would the target have been acquired by another (and potentially less anti-competitive) rival?

In most cases existing market conditions provide the relevant counterfactual (i.e. that the parties would have continued competing against each other in the market absent the merger). However, where changes to the market are imminent and can be reasonably predicted, then the regulator is likely to consider the impact of such changes in the relevant counterfactual but will wish to have as much factual evidence as possible as to the timing and likelihood of such market developments. For example, the "failing firm" defence is often argued but rarely accepted by competition authorities due to concerns as to whether the supporting evidence is sufficiently compelling.

## 8. Horizontal mergers

Of the three broad categories of mergers (discussed above), horizontal mergers between existing competitors raise the clearest risks to competition as they involve the elimination of an actual competitor in the same market. It should also be borne in mind that mergers which eliminate a potential competitor may also raise competition concerns, particularly where there is evidence suggesting that competition is already ineffective in the market and the target is one of the few potential entrants.

There are two conceptually distinct means by which a horizontal merger might be expected to give rise to competition concerns:

- through "non-coordinated" (or unilateral) effects; and
- through "coordinated" effects.

### "Non-coordinated" effects

"Non-coordinated" effects arise where a significant competitive constraint is eliminated by the merger, such that the merged entity could unilaterally and profitably increase prices (which may also lead to other firms increasing their prices without any coordination) or otherwise behave anti-competitively (e.g. by reducing quality, choice/range of products, or levels of innovation).<sup>7</sup> In other words, the merger will increase the market power of the merged entity to such an extent that it can act anti-competitively without regard to its customers, competitors or suppliers.

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<sup>6</sup> The "failing firm" defence is widely recognised by many competition authorities.

<sup>7</sup> For example, in local retailer mergers where prices are set nationally, competition authorities will often focus on the extent to which the parties could reduce quality, range and levels of service at the local level as a result of the merger in order to earn higher profits.



Competition authorities frequently focus on the extent to which the parties to the merger are close competitors. If two firms to a merger are particularly close competitors the main factor constraining their prices may be the loss of sales that would occur to the other party if it were to increase prices. In such cases, a merger between the two parties would result in a potentially significant competitive constraint being eliminated, as the fear of losing business to the other firm is lost as a result of the merger (and any such lost sales would be internalised by the merged entity).

Merger assessments tend to commence the analysis of this issue by reference to market shares, and then to consider whether market shares are reliable indicators of market power given the facts of the case. The assessment of whether firms are close competitors may involve complex economic assessments and econometric modelling, although there may also be some simple information readily available. For example, the extent of switching between the parties may be assessed in terms of customer wins/losses, and the parties' internal documents may be revealing as to which rivals they view as being the closest competitor(s).

Many of the techniques set out above in relation to testing for market definition may also be relevant to assessing unilateral effects. For example, the analysis of transaction price data may be revealing as to whether the parties to the merger are particularly close competitors. If the merging parties' prices are more closely correlated with one another than they are with other rivals' prices (extending the premise considered above that firms will have close regard to their rivals' prices), this may suggest that the parties are closer competitors to each other than they are to other rivals. The switching behaviour of the parties' customers to different rivals may also be revealed from 'shock analysis' or customer surveys. The analysis may also involve complex econometrics or merger simulations, although this is more likely to be limited to second stage cases.

More recently, many competition authorities have also been using Pricing Pressure Tests in order to provide an indication as to whether the merger may be expected to give rise to anti-competitive effects. These tests use a combination of the parties' gross margins and diversion ratios (i.e. the proportion of sales lost by one of the merging parties that would be won by the other merging party<sup>8</sup>) in order to provide an estimate of the post-merger price increase. As a general rule, the higher the parties' gross margins and the higher the diversion ratios between the parties, the more likely it is that these tests will indicate that a merger is anti-competitive.

Competition authorities may also be concerned if one of the parties to the merger is a "maverick" competitor. Maverick firms are typically smaller, aggressive, competitors, and might be identified if they have won a higher proportion of their sales from new customers, might bid for more customers than other firms (depressing prices even if they do not win business), or win a higher share than rivals of the aggregate volume of business "lost" by suppliers over a period of time. Competition from the maverick may impact more broadly on many competitors in the market, causing them to compete more actively, thereby enhancing overall market competitiveness.

Whether or not non-coordinated effects arise also depends on the ability of customers to switch to rivals. In this respect, if rival firms have sufficient spare capacity, then they may have substantial scope to increase their sales and thus defeat any attempt by the merged undertaking to increase prices. However, lack of capacity or, equally, switching costs may limit the ability of existing customers to switch to rivals.

## "Coordinated" effects

A horizontal merger may also be anti-competitive if it leads to "coordinated effects" (which are frequently referred to as tacit coordination or collective dominance). The US Horizontal Merger Guidelines states that: "Coordinated interaction is comprised of actions by a group of firms that are profitable for each of them only as a result of the accommodating reactions of the others". For example, if a firm follows the price increase of another.

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<sup>8</sup> Diversion ratios may be estimated from a variety of sources including customer surveys, win-loss reports, customer switching patterns or econometric modelling.

Firms in markets which are predominantly supplied by a small number of firms (i.e. oligopolistic markets) potentially face two obstacles to coordinating effectively: first, a consensus must be reached between a sufficient number of competitors to ensure that their accommodating conduct is profitable; and secondly, once the terms of coordination have been reached, sustaining coordination may be difficult due to the incentives of individual firms to seek to increase their market share and profits by "cheating" (e.g. by undercutting coordinated prices).

Consistent with this, the European Court of First Instance in *Airtours plc -v- Commission* has identified three conditions which must be met for coordination to give rise to concerns:

- the participants in the coordination must have an ability to align their behaviour in the market (i.e. in order to coordinate tacitly, without actual communication, firms need to be able to achieve some kind of understanding as to how to do so). For example, if market prices are reasonably transparent, it may be possible for firms to identify focal points for prices or standard discounts off price lists;
- the firms must have incentives to maintain the coordinated behaviour. This means that it must be possible to detect any deviation from the coordinated outcome and to be able to "punish" any deviation through retaliatory behaviour; and
- the coordinated behaviour should be sustainable in the face of other competitive constraints in the market (e.g. low barriers to entry and expansion, substantial buyer power, and a competitive "fringe" of smaller rivals who individually have little to gain from coordinating with larger rivals).

A key ingredient in assessing the risk of anti-competitive coordination emerging or being strengthened (if it is already occurring) is to consider the specific impact of the merger upon the factors outlined above. For example, the reduction in the number of competitors may create a more symmetrical or transparent market structure in which firms' interests are more convergent, or it may eliminate a "maverick" competitor which currently destabilises the market by competing aggressively and independently.

Such assessments may be informed by an analysis of prevailing competitive dynamics. Stability in firms' market shares is one of the features of coordination, although it is not a determinative factor as dominant firms and those in fierce competition with one another may also enjoy stable market shares. Nevertheless, it may be informative to assess the extent to which customers switch suppliers over time: the greater the degree of customer churn, the less likely it is that coordination is occurring.

Assessing trends in competitors' prices may also be revealing as to whether coordination is occurring. Observing that there is a high correlation between rivals' prices is consistent with existing price coordination, although it could also represent intense competition between the parties and/or common cost and demand changes. The relationship between published list prices and the parties' transaction prices could also be considered, since this may permit an assessment of whether "signalling" is occurring through public price announcements, as part of the tacit coordination mechanism.

Tacit coordination will typically be easier to achieve where rivals' prices and/or output are known in the market place. Since transparency or lack of transparency is easy to assert, firms' internal documents may be reviewed for evidence of such transparency (e.g. whether reliable estimates are available as to their rivals' prices to individual customers, capacities, costs and sales). The competition authority might further wish to consider whether these estimates are significantly different from reality, since this would suggest a lack of transparency, thus making consensus and detection of deviations more difficult.

## 9. Vertical and conglomerate mergers

The primary concern regarding vertical and conglomerate mergers is that a firm with market power in one market might try to use its market power to extend (or leverage) its power into a second market. By leveraging its market power in this way the merged entity may be able to foreclose the upstream/downstream or conglomerate market to competitors, and thus act anti-competitively.

The area of economics on the effects of vertical and conglomerate mergers can be controversial as there are often strong pro-competitive (efficiency) effects which must be weighed-up against the alleged anti-competitive effects. In this regard, vertical and conglomerate mergers (particularly the latter) are much less likely to give rise to competition concerns than horizontal mergers and they are more likely to give rise to efficiency benefits due to the complementary nature of the goods and services in question.<sup>9</sup>

## "Non-coordinated" effects

The European Commission's non-horizontal merger guidelines indicate that it is relevant to adopt a three-stage analysis of non-horizontal mergers, focusing on: a) the ability of the merged entity to engage in foreclosure; b) its incentives to do so (i.e. whether such a strategy is likely to be profitable); and c) whether a foreclosure strategy would have significant adverse effects on competition and ultimately consumers.

In vertical mergers, there are two principal ways in which foreclosure can take place: a strategy of input foreclosure; or a strategy of output/customer foreclosure. In relation to input foreclosure, the principal concern is that the merged entity either refuses to supply a key input to rival downstream suppliers, or only does so at inflated prices, thus reducing the ability of rivals to compete in the downstream market. In relation to output/customer foreclosure, the principal concern is that the merged entity may be able restrict access to a sufficient customer base to rival suppliers in the upstream market (e.g. by buying the upstream product from the merged entity), thus reducing the ability of rivals to compete in the upstream market.

In conglomerate mergers, the mechanisms by which such foreclosure can be achieved are usually through the tying or bundling of complementary products and services brought together by the merger. In other words, the merged entity forces customers to buy groups of products (often at a discount) which may make it difficult for rival suppliers of certain individual products to compete, either individually or across the bundle.

The ability of the merged entity to engage in foreclosure will depend, inter alia, on:

- the importance of the product to customers/suppliers (e.g. whether it is a critical component for the manufacture of downstream products or represents a high proportion of the price of the downstream product); and
- the existence of a significant degree of market power in the upstream/downstream or conglomerate market (i.e. can alternative suppliers/customers secure suppliers of alternative inputs or find alternative sales outlets).

If customers/suppliers have counter-strategies or "outside options" to reduce their dependence on the merged entity, vertical and conglomerate mergers are less likely to be a concern.

Even if the merged entity has the ability to engage in foreclosure it is also relevant to consider whether or not there is a clear profit incentive (taking into account the profits of both the upstream, downstream and/or conglomerate businesses) for the merged entity to behave in this way. In this regard, a profit incentive calculation will depend upon a number of factors, including: the type of strategic behaviour being considered; the amount of revenue that would be foregone if the merged entity was to act strategically (e.g. by refusing to supply inputs to downstream rivals or only supplying such inputs on inferior terms); and the additional sales revenue that would be gained by the merged entity due to its rivals' consequently increasing their prices.

Finally, it is also relevant to consider the extent to which rivals to the merged entity will face higher costs or a competitive disadvantage, which in turn may allow the merged entity to raise prices (i.e. it is relevant to consider the impact of the strategic behaviour on competition in the upstream, downstream or conglomerate market).

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<sup>9</sup> This is because, unlike independent suppliers, an integrated firm will have regard to the fact that if it sets higher prices for one product or service it will reduce the sales of the other complementary products or services and vice versa.

## "Coordinated" effects

In relation to coordinated effects the European Commission's non-horizontal merger guidelines follow the approach taken in relation to horizontal mergers. Accordingly, coordinated effects for vertical and conglomerate mergers should be assessed using the same framework as set out above for horizontal mergers (with particular consideration given to how the merger increases the likelihood or efficacy of any anti-competitive coordination).

## 10. Conclusion

Robust economic evidence is determinative as to the assessment of the competitive effects of a merger. The challenge for the parties to a merger and their advisers is to identify the key economic issues at the outset, and to ensure that resources are focussed on developing the factual evidence required to assess these issues (notwithstanding the possible distraction of long merger filing forms). The same points apply for the third parties contemplating complaining about a merger - what makes a complaint most credible is the factual evidence provided. As the complexity in the economic analysis increases, it is vital that any economic analysis is robust (e.g. to changes in specifications and assumptions), which the competition authorities will inevitably test.

It is also important that legal and economic analysis is fully integrated into submissions since this ensures the consistency and robustness of the case put forward. Economists are adept at developing ever increasing theories of harm, whereas competition authorities need to focus on accepting or rejecting such theories on the basis of the overall body and balance of factual evidence and having close regard to the requisite legal standards. The integration of lawyers and economists at Ashurst, which matches up with the case teams of many of the competition authorities around the world, ensures that the parties are always able to put their best case forward.



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