Closeness of Competition in EU Merger Control

Legal Comments

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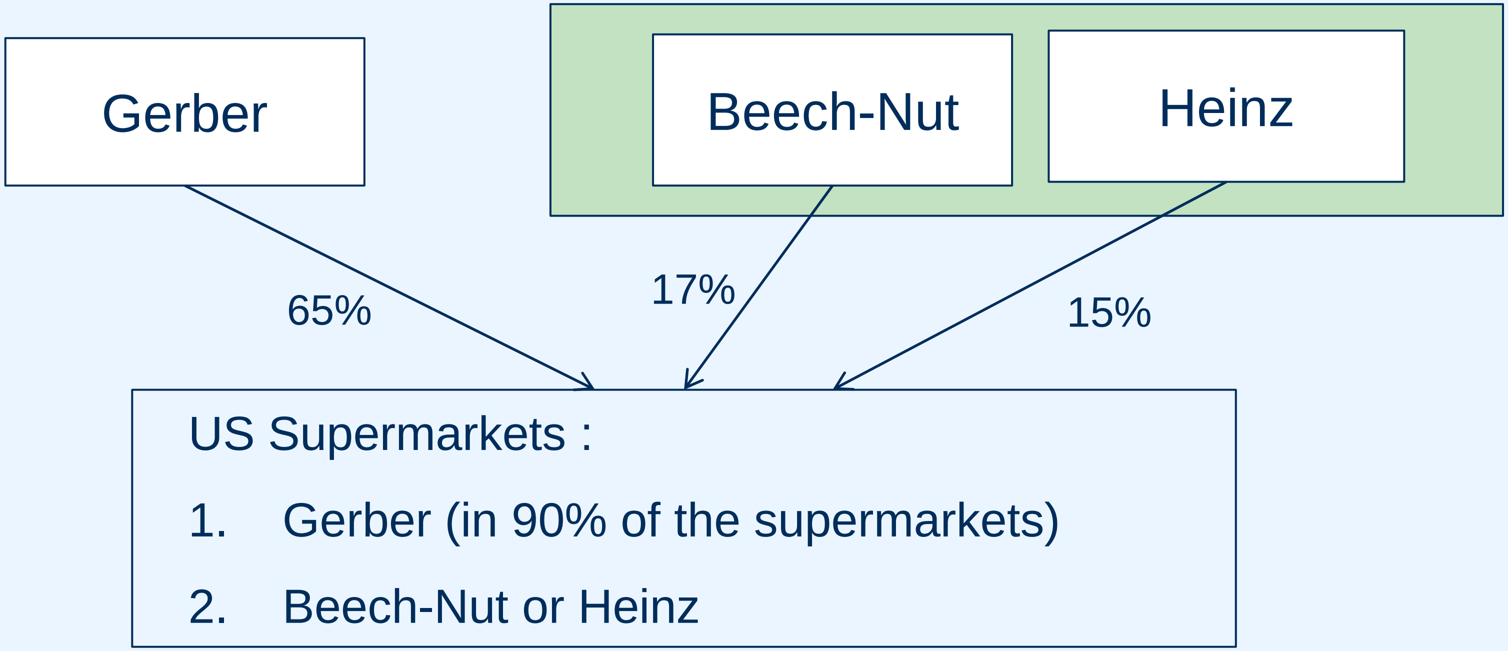
Horizontal merger control scenarios

Merger to monopoly	→	Effectively per se prohibition
Merger to duopoly	→	Strong presumption of anticompetitive effect
4-to-3 merger	→	???
5-to-4 merger	→	Might raise concerns in some instances
Merger leaving 5+ competitors	→	Unlikely to raise concerns

Legal standards applied to the various scenarios

Coordinated effects		Non- Coordinated effects
-	Merger to monopoly	Single dominance
"Joint dominance"	Merger to duopoly	Non-coordinated effects other than dominance
Airtours requirements	4-to-3 merger	Non-coordinated effects other than dominance
Airtours requirements	5-to-4 merger	Non-coordinated effects other than dominance
-	Merger leaving 5+ competitors	-

US example of a straightforward application of closeness in oligopolistic mergers



> A merger of Heinz and Beech-Nut is likely to result in unilateral anticompetitive effects by eliminating retailers' ability to choose between two close substitutes for the second baby food slot on their shelves. *See Merger Guidelines* § 2.2. Heinz and Beech-Nut not only are close substitutes, they are the *only* brands that can serve retailers' needs for the second baby food slot.

Memorandum in support of the FTC's motion got preliminary injunction (Sept. 15, 2000), p.23

EUMR on horizontal mergers in oligopolistic markets

(25) In view of the consequences that concentrations in oligopolistic market structures may have, it is all the more necessary to maintain effective competition in such markets. Many oligopolistic markets exhibit a healthy degree of competition. However, under certain circumstances, concentrations involving the elimination of important competitive constraints that the merging parties had exerted upon each other, as well as a reduction of competitive pressure on the remaining competitors, may, even in the absence of a likelihood of coordination between the members of the oligopoly, result in a significant impediment to effective competition. The

Merger Regulation, recital 25

- Need to differentiate between mergers which harm competition and those that do not

Laundry list of non-coordinated effects criteria

26. A number of factors, which taken separately are not necessarily decisive, may influence whether significant non-coordinated effects are likely to result from a merger. Not all of these factors need to be present for

Horizontal Merger Guidelines, para. 26

Parties have large market shares	Competitors unlikely to increase supply if prices increase
Parties are close competitors	Merged entity able to hinder expansion by competitors
Customers have limited possibilities of switching suppliers	Merger eliminates an important competitive force

Not all factors need to be present… List non-exhaustive…

Problem : no ultimate "plausibility check" like in dominance scenario

Closeness as a question of degree?

The Horizontal Merger Guidelines clearly provide for a relative approach to the relevance of closeness of competition. According to paragraph 28 of the Horizontal Merger Guidelines, the higher the degree of substitutability between the merging firms' products, the more likely it is that the merging firms will raise prices significantly. The same concept is set out in paragraph 17 of the Horizontal Merger Guidelines, according to which a merger may raise competition concerns based on "*the extent to which the products of the merging parties are close substitutes*". Both wordings set out a positive correlation between the degree of substitutability between the products of the merging parties and the likelihood and seriousness of the competition concerns raised by the proposed merger.

SO Case M.7612 – Hutchison 3G UK / Telefónica UK, para 327

Based on the above, the Commission preliminarily concludes that the Parties are close competitors on the overall retail market for mobile telecommunications services (and segments thereof) in the United Kingdom.

SO Case M.7612 – Hutchison 3G UK / Telefónica UK, para 367

Taking all elements of the assessment into account, the Commission finds that Telefónica and E-Plus are close competitors. While the review of the internal documents provides only some indication to that effect, the answers to the Market Investigation support this finding. The same applies to the diversion ratios in the pre-

Case M.7018 Telefónica Deutschland/E-Plus, para 320

Which degree of closeness indicates concerns?

Diversion ratios in 4-to-3 mergers challenged by the Commission

Segment	T-Mobile / Tele.Ring	Austria	Ireland	UK
Purchaser (UK: H3G) > Target (UK: O2)				
Private post-paid	[50-60]%	28%	18%	13%
Private pre-paid		N/A	24%	N/A
Target (UK: O2) > Purchaser (UK: H3G)				
Private post-paid	N/A	23%	31%	22%
Private pre-paid	N/A	N/A	19.5%	N/A

- Very low and very different degrees of closeness lead to a confirmation of closeness

How do you measure closeness?

Diversion ratios (i.e. switching rates of customers between suppliers) have been measured in different ways:

- Looking at the diversion ratios as such
- Comparing them to "benchmark diversion ratios" based on either stock market share or gross add share

(184) The MNP switching data, which covers the period from 2009/Q1 to 2012/Q1,[133] shows, as the Notifying Party acknowledges, that H3G is winning many more customers than it is losing. This pattern is consistent with H3G's growing subscriber base. H3G loses customers in similar proportions to all competitors and wins customers in particular from TA, but to a lesser extent than TA's market share would suggest.[134]

(186) If, as the Notifying Party argues, switchers were (at least on average) equally likely to choose any mobile operator because they all offer very similar products, then each MNO would be expected to capture switchers proportionally to its competitors' relative market shares. The Notifying Party itself has acknowledged, however, that H3G's share of all switching customers based on MNP data is 31% and its share of all customers switching from Orange is 29%. This is broadly consistent with market shares only on the assumption, apparently acknowledged by the Parties, that the correct measures of competitive strength are the shares based on new business.[135]

Case M.6497 – *H3G/Orange Austria*, para. 184 and 186

What is a “substantial number” of customers?

For example, a merger between two producers offering products which a substantial number of customers regard as their first and second choices could generate a significant price increase. Thus, the fact that rivalry

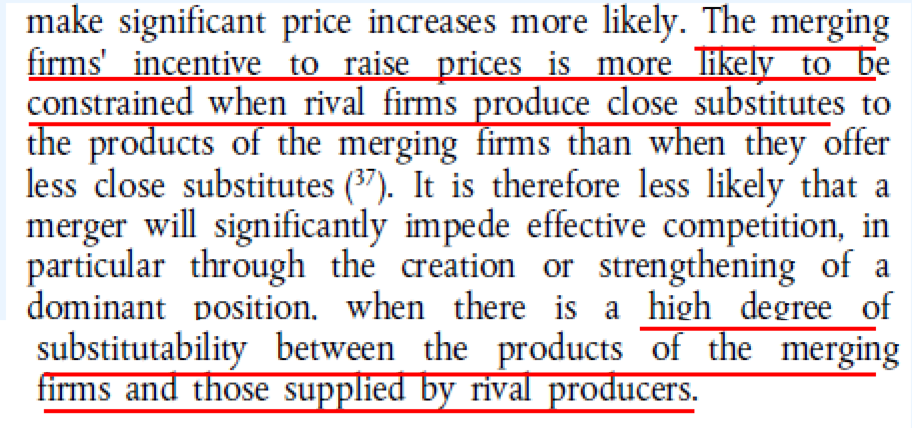
Horizontal Merger Guidelines, recital 28.

Calculation of number of customers who have the parties as their 1st and 2nd choice	Pre-pay	Post-pay
Customers who have Party 1 as their first choice	7%	17%
…of which have Party 2 as their second choice	21.0%	22.0%
Total customers who prefer Party 1 then party 2	1.5%	3.7%
Customers who have Party 2 as their first choice	31%	23%
…of which have Party 1 as their second choice	19.0%	13.0%
Total customers who prefer Party 2 then Party 2	5.9%	3.0%
Overall customers who have Party 1 and Party 2 as their first and second choices	7.4%	6.7%
Percentage of the Merged Entity’s customers who have Party 1 and Party 2 as their first and second choices	19%	17%

… only 7% of all customers consider Party 1 and Party 2 to be their 1st and 2nd choice

High degree of substitutability with competitor products

Horizontal Merger Guidelines, para. 28:


make significant price increases more likely. The merging firms' incentive to raise prices is more likely to be constrained when rival firms produce close substitutes to the products of the merging firms than when they offer less close substitutes (37). It is therefore less likely that a merger will significantly impede effective competition, in particular through the creation or strengthening of a dominant position, when there is a high degree of substitutability between the products of the merging firms and those supplied by rival producers.

Close, closer, closest…

The claims of the Notifying Party that the Parties must be each other's "closest" competitor and that only the "absolute" diversion ratios should be taken into account without comparing them to the market shares of the Parties contradict the concept of closeness set out in the Horizontal Merger Guidelines.

Case M.7018 Telefónica Deutschland/E-Plus, para 277

For this reason, previous decisions of the Commission stating that the respective merging parties' products are each other closest substitutes do not support the claim by the Notifying Party that only a merger between closest competitors raises competition concerns. If the merging parties' products are each other's closest substitute, the competition concerns may be particularly strong. However, a merger between firms producing close, but not necessarily the closest substitutes also makes price increases more likely than a merger between firms producing products with a low degree of substitutability. For this reason, the heading preceding paragraph 28 of the Horizontal Merger Guidelines reads: "Merging firms are close competitors".

Case M.7018 Telefónica Deutschland/E-Plus, para 280

Close, closer, closest…

- „Porsche / Volkswagen“ (2008, para 59), customers do not consider Porsche‘s and VW‘s cars as closest („engstmöglich“) substitutes but rather cars produced by BMW, Ferrari or Mercedes-Benz

Die Marktuntersuchung hat die Argumente des Anmelders bestätigt. Die verschiedenen Modelle von Porsche und Volkswagen auf diesem Teilmarkt sind für die Verbraucher nicht die engstmöglichen Substitute. Als naheliegendste Substitute für die betreffenden Porsche- und Volkswagenmodelle werden vielmehr eine Vielzahl anderer Modelle von verschiedenen Herstellern (BMW, Ferrari, Mercedes-Benz und andere) genannt.

- „Kraft Food / Cadbury” (2010, para 57), combined market share of 60-70% in the UK but

Kraft chocolate brands are also not seen as closest competitors to any of Cadbury's chocolate tablet brands. In fact, Mars Galaxy was seen by almost all market participants as Cadbury Dairy Milk's closest competitor. In addition, Cadbury's other major brands Bournville and

- „Close“ competitors in closeness „offence“ but „closest“ competitors in closeness „defence“?

Close, closer, closest…

COMP M.5644 Kraft Foods/Cadbury

Merging parties not being "closest" competitors as an element used to set aside competitive concerns in:

- the UK:

Combined market shares [60-70]%; increment [5-10]%

57. Kraft chocolate brands are also not seen as closest competitors to any of Cadbury's chocolate tablet brands. In fact, Mars Galaxy was seen by almost all market participants as Cadbury

- Ireland;

82. Taking into account the absence of significant competition between Kraft's Toblerone and Milka and Cadbury's brands, it is concluded that the proposed transaction does not raise serious doubts on the chocolate tablets' market in Ireland.

- France;

91. The fact that Kraft's and Cadbury's products are not the closest competitors is further documented by an assessment of the positioning of the different brands. For example in

Merging parties being "closest' competitors as an element leading to competitive concerns in:

- Poland

115. The market investigation also indicates that Cadbury is the closest competitor to Kraft with respect to price, shelf presence, innovation, promotion and product range. The market

- Romania

134. Kraft and Cadbury are perceived by a majority of competitors and customers as the closest competitors in terms of brand positioning. Brand image constitutes the main criterion in

Is closeness a problem in itself?

Closeness of competition is a necessary but not a sufficient condition for a finding of competitive concerns

- Economic goal to measure:
  - The degree of substitution between the products of the merging parties
  - The post-merger incentive to increase prices

- Two factors are driving this under standard economic principles:
  - Closeness
  - Gross margins

- The UPP model has been developed to quantify the post-merger incentives to increase prices

Is closeness a problem in itself?

- General principle underlying the UPP test:
  - High closeness + High margins = high predicted price increases
  - Low closeness + Low margins = low predicted price increases
  - High closeness + Low margins (or vice versa) = mixed results

- Based on the Commission's practice, it is therefore the UPP model which provides indications as to whether there is a closeness concern

- Closeness as such is therefore not a conclusive indicator that a merger will harm competition

- If a UPP test is made, does a separate finding of "closeness" provide anything in addition?

High-level comments on the UPP model

- UPP model predicts price increases for every horizontal merger

- In order to draw useful conclusions from the UPP model; one of two steps have been made:
  - Factor in the efficiency effects of the merger (through decrease of marginal costs); or
  - Define a threshold which separates the mergers that harm competition from those which do not (5%?)

- The practice of the Commission is:
  - The parties bear the burden of proof for the efficiencies
  - No threshold – even predicted price increases for below 5% are used as evidence against the merger

How to measure closeness using the UPP analysis?

UPP analysis against reference UPP predictions:

UPP in the "baseline scenario" across different merger cases			
Post-paid	Country 1	Country 2	Country 3
Merging party 1	17.4%	19.3%	13.0%
Merging party 2	13.4%	11.6%	8.6%
Overall segment	n/a	10.6%	5.8%
Pre-paid	Country 1	Country 2	Country 3
Merging party 1	n/a	33.9%	35.0%
Merging party 2	n/a	19.3%	18.5%
Overall segment	n/a	11.7%	11.2%
Total private	Country 1	Country 2	Country 3
Overall segment	n/a	11.2%	6.7%

Commission does not appear to draw conclusions from UPP predictions at different levels – Commission concludes that there will be "significant price increases" irrespective of the level of increase (even with UPP predictions of less than 5%)

How to measure closeness using the UPP analysis?

UPP predictions compared to hypothetical alternative scenarios

Comparisons			
Post-paid	Symmetric 4 to 3	Symmetric 5 to 4	Merger
Merging party 1	17.8%	11.4%	13.0%
Merging party 2	17.8%	11.4%	8.6%
Overall segment	12.5%	6.8%	5.8%
Pre-paid	Symmetric 4 to 3	Symmetric 5 to 4	Merger
Merging party 1	27.8%	17.8%	35.0%
Merging party 2	27.8%	17.8%	18.5%
Overall segment	19.5%	8.9%	11.2%
Total private	Symmetric 4 to 3	Symmetric 5 to 4	Merger
Overall segment	13.7%	7.5%	6.7%

How to remedy closeness concerns?

The Commission's UPP model can be used to look at the predicted post-merger price effects if the Divestment Business is spun off in a remedy

(a) Network Level				(b) Provider Level			
Segment	Pre-paid	Post-paid private	Overall Private	Segment	Pre-paid	Post-paid private	Overall Private
Party 1	34.5%	8.2%	10.8%	Party 1	27.6%	8.2%	10.1%
Party 2	11.6%	0.3%	3.2%	Party 2	9.8%	1.2%	3.1%
Party 3	4.1%	-1.1%	-0.5%	Party 3	1.9%	-0.6%	-0.3%
Party 4	3.1%	-1.8%	-1.0%	Party 4	1.8%	-1.5%	-1.1%
Divestment Business	-16.2%	-14.7%	-15.1%	Divestment Business	-17.1%	-13.9%	-14.8%
Segment Effect*	7.7%	-0.2%	1.1%	Segment Effect*	4.7%	0.3%	1.0%

How to link the closeness analysis to the SIEC test?

No per-se prohibition of oligopolistic mergers

=> standard to be developed which differentiates between effects of all horizontal mergers and those leading to a SIEC

Introduction of SIEC test did not lower intervention threshold

“The [new] test could not be interpreted as a lowering of the intervention threshold […] The standard of incompatibility of mergers will therefore be the same”

Philip Lowe, speech at Italian Competition/Consumers Day, Rome, 9 Dec 2009

Competitive harm needs to be comparable with that arising from creation of a dominant position (HMG, para. 4)

dominance. As a consequence, it is expected that most cases of incompatibility of a concentration with the common market will continue to be based upon a finding of dominance. That concept therefore provides an important indication as to the standard of competitive harm that is applicable when determining whether a concentration is likely to impede effective competition to a significant degree, and hence, as to the likelihood of

Nearly limitless expansion of the concept of closeness

Commission findings:

„The Horizontal Merger Guidelines refer to merging firms being ‚close competitors' as opposed to being each other's closest competitors." *(H3GA/Orange Austria, para. 200)*

It is not necessary that a majority of the customers regard the parties as the closest competitors; a „substantial number" is sufficient. *(H3GA/Orange Austria, para. 176)*

„In any event, the Market Investigation indicates that the Parties are close competitors in the sense that a <u>significant number of subscribers [23/27%]</u> currently switch from one to the other, even if they are not necessarily the closest competitors." (Irish 6-1-c decision, para. 90)

„The purpose of the analysis is to show that there exist dimensions in which the parties are close [...]" (*H3GA/Orange Austria*, para. 178)

In a 4-player market, all competitors may be "close"

market and the segment for the provision of services to private customers. In the current competitive landscape, all MNOs, including Three and O2, play an active role and compete closely with each other[272] on the basis of the parameters of competition indicated in Section 6.6.2.

and Vodafone, the Commission preliminary considers that currently Three and O2 compete closely with each other. The competitive pressure exerted by Three and O2 on each other is nothing but the demonstration of the vigorous competitive dynamic existing between MNOs in the retail market for mobile telecommunications services in the United Kingdom. The rivalry between the Parties has been an important source

SO Case M.7612 – Hutchison 3G UK / Telefónica UK, paras. 330-331

Without denying the close competitive interaction that exist between the Parties, EE and Vodafone, the Commission preliminary considers that currently Three and O2 compete closely with each other. The competitive pressure exerted by Three and O2

SO Case M.7612 – Hutchison 3G UK / Telefónica UK, para. 331

In a 4-player market, every competitor may be an ICF

For a firm to constitute an important competitive force, it is not necessary to be a maverick on the market. Rather, such a party has to contribute, substantially and consistently, to the competitive process on the market based on such parameters as price, quality, choice and innovation. A merger involving a company which a recent

SO Case M.7612 – Hutchison 3G UK / Telefónica UK, para. 380

In this context the Commission agrees with the Notifying Party that all MNOs compete vigorously in the retail market for mobile telecommunications services in the United Kingdom.

However, the Commission notes that this is a highly concentrated market. As shown

In such a concentrated market each MNO plays today a very important role in the competitive dynamic and constrains the others, as shown by the diversion ratios and illustrated in Figures 33 and 34 above.

SO Case M.7612 – Hutchison 3G UK / Telefónica UK, para. 381-383

Conclusion – Lack of a clear standard of closeness...

... and many open questions

- Concept used appears to lead to per-se objections to oligopolistic mergers – lack of a limiting principle
- Confusion between closeness as an absolute or a relative concept
- Practical approach may lead to the same conclusion for very different degrees of closeness
- Even very low levels of closeness are used to object to mergers
- Is closeness itself an indicator which is different from the UPP predictions?
- UPP analysis: no threshold defined; ill suited for markets with large fixed costs
- Subjective evaluation of „qualitative evidence“
- No link back to the legal test
  - „significant“ impediment to effective competition
  - Dominance as indicator for the degree of competitive harm
  - Relevance of closeness within coordinated effects laundry list unclear

Key question unsolved: how to perform a unilateral effects analysis in oligopolistic markets?