

CRA Competition Memo



“Indirect effects” in merger analysis

The standard starting point for merger assessment is the identification of areas in which the merging parties’ activities overlap either vertically or horizontally. But in increasingly many mergers assessed by the European Commission, competition concerns are considered to arise even where there is no direct overlap between the merging parties. This growing focus on “indirect effects” of mergers mean that the conventional analysis of mergers, based on assessing changes in concentration in appropriately defined relevant markets, may no longer be sufficient to identify all potential competition issues.

Lexecon’s competition memo of April 1998 discussed one particular example of a concern raised by such indirect effects – the effect known as “portfolio power”, which relates to the combination of brands in separate relevant markets and which arose in the context of the *Guinness/Grand Metropolitan* merger. Portfolio power is not a unique example: several other types of indirect effect have been identified by the Commission. Recent cases where indirect effects figured in the Commission’s analysis include *Telia/Telenor* and *Vodafone AirTouch/Mannesmann*.

A particularly good illustration of the variety of ways in which indirect effects can cause concern is provided by the Commission’s (so far unpublished) reasoning in assessing the joint bid for BOC by Air Liquide (AL) and Air Products earlier this year.¹ The indirect effects identified by the Commission in this case included:

- the elimination of *potential competition*;
- the increased scope for *retaliation*; and
- combination of dominant positions, raising the possibility of “*leverage*”.

This memo outlines how the Commission’s analysis of indirect effects in the AL/BOC case and discusses the implications for the future analysis of mergers.

The Air Liquide/BOC case

All of the parties to the intended transaction were active in the supply of a range of industrial gases (gases such as oxygen, nitrogen, carbon dioxide, helium and others, for use in a wide variety of industrial processes). The Commission’s assessment covered a number of product markets, but for present purposes the key markets at issue were those for the supply of air gases (oxygen, nitrogen, carbon dioxide and argon) through each of two channels: *bulk supply*, which involves large volumes being provided to the customer by means of tanker

trucks; and *cylinder supply*, which is low-volume supply of gases in metal cylinders.

Indirect effects in the bulk and cylinder gas markets

The Commission concluded that both the bulk and cylinder markets were, at most, national in geographic scope. In Europe, BOC’s bulk and cylinder air gas activities were restricted to the UK and Ireland.² AL was active in a number of European countries, but not in the UK or Ireland. The merger had no vertical dimension in these product markets. Consequently there were no direct overlaps – whether horizontal or vertical – in the bulk or cylinder supply of air gases. Nevertheless, on the basis of concerns over various indirect effects, the Commission concluded that the merger would lead to a strengthening of dominant positions in these markets.

• *Elimination of potential competition*

In considering potential competition, the Commission focussed in particular on the removal of AL as a potential competitor to BOC in the UK. In view of its size and global presence, AL was regarded by the Commission as being the most credible potential entrant into the UK. The fact that AL had not previously entered the UK market was dismissed as a “strategic business decision” which could be changed at any time. The Commission argued that this meant that there were no “objective factors” preventing entry into the UK. This logic is rather strange – particularly the suggestion that strategic business decisions are inherently not based on objective factors. Perhaps most importantly, the Commission’s analysis involved no serious consideration of *why* AL had chosen not to enter the UK in the past, and whether this might change in the future.

The Commission also argued that BOC was a credible potential competitor to AL in France. As evidence of this, it cited the fact that BOC had in the past established operations in continental Europe (Belgium and Netherlands). BOC had recently sold these operations to AL in a separate transaction – i.e. had decided to exit continental Europe. If anything, it would seem that the more obvious interpretation of this fact is the opposite of the Commission’s – namely that BOC should *not* be regarded as a particularly likely or imminent potential entrant, having attempted entry in the past and having recently chosen to withdraw.

¹ Lexecon acted as advisor to Air Products in relation to the EC merger control aspects of this transaction (the planned merger was cleared by the Commission subject to disposals, but was eventually abandoned after opposition from the US authorities, reflecting the greater degree of overlap between the merging parties in the US).

² The Commission also expressed concern over the elimination of *actual* competition between AL and BOC by virtue of an earlier, separate transaction in which AL had purchased BOC’s bulk and cylinder operations in the Benelux countries. This memo does not discuss the earlier deal, but it is interesting to note that the Commission took the view that the earlier transaction (which was not notifiable under the EC Merger Regulation and had been cleared by the relevant national authorities) should be re-assessed as part of the wider AL/BOC acquisition.

The Commission's willingness to object to a merger on the grounds that it removes *potential* competition raises some serious questions. Such a conclusion could be justified if it is based on evidence that current pricing in the market is influenced by the threat of entry – i.e. that the market is to some degree “contestable” – but this was not what the Commission was claiming. Instead, the Commission's reasoning suggests a more conservative rationale for its conclusion: the simple fact that neither party would have remained as a potential independent competitor to the other – whether or not there was evidence to suggest any appreciable likelihood that this would make a difference to the market outcome – is seen as sufficient to cause concerns. This type of argument, if taken to its logical conclusion, would represent a very severe approach indeed to merger control.

- **Increased scope for retaliation**

A second strand of the Commission's analysis was a concern that the enlarged group would have greater geographic coverage than either of the parties alone (i.e. that there would be an increase in “multi-market contacts” between competitors), and hence would be in a better position to “retaliate” against competition from third parties by cutting prices in markets where the competitor is already established. This would increase the loss that the enlarged group could inflict upon a competitor in an attempt to discourage it from competing. This amounts effectively to a claim that the merger would lead to (or reinforce) some kind of tacit market sharing agreement within the European industry, whereby competitors coordinate the extent to which they attempt to gain market share in various territories, and face retaliation if they do not respect the “agreement”.

It is clear from the economic theory of multi-market contacts that the circumstances in which a merger could, even theoretically, lead to such behaviour are very limited. The mere fact that a merger makes it more *feasible* for a company to respond to competition in one market by actions in a different market does not mean that it would be *rational* to do so. The Commission did no more than observe the feasibility of retaliation, and did not consider the equally important question of whether such behaviour would make commercial sense. Moreover, the Commission did not offer any market evidence to suggest that this type of behaviour had actually occurred, or would be likely to occur, in the industrial gases industry.

- **Combination of dominant positions / “leverage”**

A further concern identified by the Commission was the notion that by bringing together dominant positions in the parties' respective “home” markets (UK/Ireland for BOC; France for AL), the merger would strengthen dominance on these home markets. In part, this concern appeared to be little more than the observation that the combined entity would overall be bigger than either party alone. The Commission believed this would raise entry barriers by increasing the scope for anti-competitive behaviour in general.

More specifically, the Commission considered that the combined entity would somehow be able to “leverage” its dominance from one market to another. It was suggested that a combined AL/BOC would be able to win multi-national customers by offering advantageous

terms in the UK in order to win that customer's business in France, or *vice versa*. However, there is no suggestion – even in the Commission's own reasoning – that such actions would be anti-competitive, and the supposed consumer detriment was far from clear.

In a similar vein, the Commission also suggested that the parties could use their home markets as a “base” to compete in other markets, meaning that they could use profits earned in their home markets to fund a strategy of undercutting competitors in other markets, in order to increase market share. According to the Commission, the likelihood of such actions would increase post-merger owing to the elimination of the “reciprocal moderation” which the parties previously exercised on one another – i.e. the threat of potential competition.

Even if the potential competition argument were accepted, this logic is hard to follow. For one, it is not clear that companies will wish to use profits from a market in which they have a strong position in order to fund undercutting in other markets. Once again, the existence of profit streams from a home market may at most affect the *ability* to behave in this way, but not the *incentive*. Moreover, unless the Commission's suggestion is that such behaviour would be predatory, then it is not clear what its objection might be.

Conclusion

The identification of “indirect” competitive effects from a merger – effects which arise from neither horizontal nor vertical overlap between the merging parties – is becoming an increasingly common phenomenon in EC merger control. It is reasonable to argue that there might be ways in which a merger could reduce competition even without a direct overlap, whether vertical or horizontal. But such effects will arise only in limited circumstances, and in very specific ways.

The mere fact that a merged entity will be bigger than its constituents is certainly not sufficient to raise concerns. Similarly, it is not sufficient merely to observe that the ability to engage in anti-competitive behaviour might be enhanced (if indeed it is), without considering whether such behaviour would be rational. The Commission's analysis in the AL/BOC case was often unconvincing in both logic and use of evidence, and involved a substantial amount of speculation about hypothetical future behaviour with little attempt to investigate the likelihood of such behaviour. This raises concerns about the burden of proof the Commission believes is required to identify indirect effects.

Whatever the merits of the Commission's arguments about indirect effects in any particular case, it is clear that companies cannot now presume that they will face an easy ride in the merger control process if their merger does not involve direct overlaps. The principle that indirect effects can raise legitimate competition concerns is no doubt here to stay. It is to be hoped that the Commission's practice in assessing such effects will develop on the basis of sound economic analysis, and that this will clarify the circumstances under which such effects raise competition concerns.

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