

CRA Competition Memo



Joint Dominance

The CFI Judgement on *Gencor/Lonrho*

The recent judgement of the Court of First Instance on Gencor's appeal against the Commission's 1996 prohibition of the *Gencor/Lonrho* merger¹ has already achieved the status of a standard reference point for officials and practitioners alike. A victory for the Commission (the Court upheld the decision on every single point raised by the applicant, from procedure to jurisdiction to interpretation of the evidence), the judgement is widely viewed as the 'new learning' on the application of oligopoly theory to merger control.

What is Joint Dominance?

'Joint dominance' is a legal concept with no direct equivalent in economics. Broadly speaking, joint dominance can be thought to occur when a small number of large firms in a market are able to co-ordinate their actions and maintain prices above the competitive level. The co-ordination need not be explicit: there is no need to meet in smoke-filled rooms to agree on future behaviour if firms can learn to 'play the game' to their mutual advantage (hence this co-ordination is also referred to as 'tacit collusion'). Successful co-ordination requires not only being able to reach agreement on prices or output levels and to monitor them, but also that some 'punishment' strategy is available to deal with 'cheating'.

While there is no agreed 'test' for joint dominance, in the Commission's view the following factors in a market are typically thought to facilitate co-ordination.

- High concentration levels
- Stable and symmetric market shares
- Similarity of cost structures
- Stagnant demand
- Inelastic demand
- Homogeneous products
- Low levels of technological change

Structural Links: a Side Show

On some issues the CFI judgement does provide welcome clarification. For example, it finally does away with any residual notion that the existence of 'structural links' between the remaining undertakings in a market is a necessary or a sufficient condition for the existence of 'joint dominance' after a merger. The debate over what constitutes structural links, and their significance for a finding of joint dominance, had not fully subsided even after last year's ECJ judgement on the *Kali+Salz* decision² found that the Commission had not proven how the likelihood of co-ordination was enhanced by the links.³

¹ *Gencor/Lonrho*, Case No. IV/M.629.

² *Kali + Salz/MdK/Treuhand*, Case No. IV.M.308.

³ *France and Others v Commission* (1998) ECR I-1375.

It is of course possible that a common commercial interest between competitors – for example on another product or geographic market – could facilitate co-ordination between them even without explicit collusion, if it opens communication channels that make co-ordination easier. However, these links can never be more than a 'side show' in the assessment of joint dominance. There should be no need for the parties to spend time in future discussing whether a marketing joint venture in Latin America or Canada between one of them and a major competitor would spell doom for the merger.

Joint Dominance as 'Tacit Collusion'

A major contribution of the judgement is perceived to be its explicit identification of joint dominance with the economic concept of *tacit collusion*. The Court makes it clear that explicit collusion, as any other instance of abuse which may materialise after the merger, would have to be dealt with under Articles 85 and 86. The focus of merger control should be instead on whether the merger will increase the feasibility of *co-ordination*, or tacit collusion.

Here is where it gets complicated. Economically no meaningful distinction can be drawn for purposes of prevention between explicit and tacit collusion because what sustains collusion is the same essential mechanism. In the short run each of a small group of large firms in the market has an incentive to 'cheat' on the agreement, for example by undercutting the 'agreed' price. What prevents them from doing so, as no enforceable contract can be written, is the threat that prices will fall much further in future (through punishments). Thus what matters is not the exact mechanism by which firms can agree on a price increase, but the existence of a *credible mechanism to keep prices at that level*.

In other words, if we interpret joint dominance as 'collusion' in the economic sense, what is important in merger control is preventing co-ordination *in circumstances where it looks likely that it could be sustained* (in economic terms, where co-ordination is 'incentive compatible'). In practice this means it is not enough to make a case that after the merger the remaining firms have an incentive to co-ordinate on a higher price. It must also be the case that, in the circumstances of the market, a sustainable mechanism exists by which the threat of lower prices in future will make it rational for them to stick to the higher price, despite the fact that in the short term they have an incentive to undercut.

The Case

The *Gencor/Lonrho* merger would have brought together the platinum activities of Implats (owned by Gencor), and Eastplats/Westplats (owned by Lonrho's LPD), and thus reduced from three to two the number of companies controlling platinum reserves in South Africa – which at the time was estimated to account for nearly 90% of world

known reserves. In terms of output, the two remaining South African producers (Amplats and the new Implats/LPD) would have accounted for around 35% each of world platinum production. The merger would have thus 'closed the gap' in market share between the market leader Amplats and the follower Implats – thus reducing 'asymmetries' between firms, which are generally accepted to render co-ordination more difficult. The Commission also pointed out that bringing together a high-cost producer (Implats) and a low-cost producer (LPD) meant that asymmetries in costs between the top two firms were being eliminated.⁴ Together with the high fragmentation of marginal supplies (Russia, new entrants, recycled metal, operational and speculative stocks) these factors were found to support a likely increase in 'joint dominance' as a result of the merger.

The judgement of the Court concludes that the Commission was right to prohibit the merger, noting that '*the concentration would have had the direct and immediate effect of creating the condition in which abuses where not only possible but economically rational, given (...) the lasting alteration to the structure of the markets concerned*' (para 94). The 'structure of the platinum market', and the fact that the 'two main producers would have had broadly similar cost structures' would have meant that '*anti-competitive parallel conduct would, economically, have constituted a more rational strategy than competing with each other, thereby adversely affecting the prospect of maximising combined profits*' (para 236).

Assessing Joint Dominance in Mergers

There are two distinct elements to collusion in the economic sense: one is how firms come to an agreement, for example how they decide what price they should charge. This is usually referred to as 'co-ordination'. The second element is how to ensure that no-one has an incentive to deviate from that price. This is what economists describe as the *credibility* of the co-ordination. Enforcement against explicit collusion is generally aimed at the co-ordinating mechanism – firms are punished for just 'trying' to talk. Merger policy, which is preventative, should be based firmly on the second – the credibility of sustaining collusive prices in future.

The CFI judgement puts emphasis on the market becoming more concentrated, but is less explicit on the question of how difficult it would have been for the remaining firms in the market to *sustain* the collusive mechanism. Market structure criteria are, of course, important in assessing joint dominance, but the key issue is the extent to which co-ordinated action is 'credible' and how the new market structure affects this credibility. The question must be whether the merger would change market circumstances in such a way that co-ordination becomes significantly easier to maintain. This does not mean that the authorities actually have to predict whether the firms are going to co-ordinate or not. Instead they need to assess in detail how credible it would be for the firms to sustain the co-ordination – but whether it is rational for them to do it, or attractive because it increases profits, is in effect a

⁴ In fact it is not clear how bringing together a high-cost and a low-cost player creates a player with 'medium' average costs: the relevant cost for all pricing decision is the cost of the marginal shaft – and it cannot be simply assumed that the combination of Implats' higher-cost shafts and LPD's lower-cost shafts would have made the merged firm more symmetric with Amplats in the relevant sense.

secondary issue.

Specifically in the *Gencor/Lonrho* case, it would seem important to establish the credibility of the co-ordination in two main areas. First, platinum is a commodity traded on open markets, with prices in long-term contracts based on spot and futures prices. If contract prices are fully indexed to open market prices, then for any significant price effect to materialise some form of manipulation of the spot and futures market by the producers would have to be postulated. To assess the credibility of co-ordinated efforts to raise prices, it would be important to assess for example what would be the cost to a producer of holding back production and running up stocks in order to support the price. Evidence that the costs of varying production are large, and producers bring to market all their output at a fairly constant rate, would have to be considered.

Further, there was the important question of what would happen to the expansion of capacity in South Africa after the merger. Arguments that the merger would have allowed the parties to slow down their capacity expansion relative to the pre-merger situation are not about joint dominance. Instead they are simply a *unilateral effect*: any merger has the effect of removing the competition *between* the parties. In joint dominance, the issue is whether future capacity expansion plans can be slowed down in a co-ordinated fashion. Since capacity expansions are lumpy decisions, large and infrequent, it is not at all clear how cheating and punishment mechanisms would work in such a scenario. As to closing down capacity, each firm may be reluctant to take a step if it fears that others may not follow, and as a result may end up losing market share (as well as the capacity to 'punish' others in future). Co-ordination on capacity is generally difficult to achieve.

Conclusions

The *Gencor/Lonrho* judgement is a step ahead although it cannot be the last word on joint dominance. Even in economics the analysis of tacit collusion is ambiguous and difficult to understand, and it will be some time before EU legal rules fully reflect the complexity of the underlying economics.

What should not happen in the meantime is that the analysis of 'joint dominance' should be reduced to a 'box ticking' exercise, with each market assessed on the basis of whether the products are 'homogeneous', demand 'stagnant', the rate of technological change 'low' and so on. Yet there is some evidence that this process may be taking root. In last year's merger of Price Waterhouse and Coopers & Lybrand, for example, the possibility of joint dominance was investigated in detail: audits were described as homogeneous (despite having to be tailored to each firm's specific situation) and technology was described as mature (despite huge investment in information retrieval systems). Although in that case the possibility of post-merger joint dominance was rejected, there is a risk that merger outcomes might become dependent on semantic interpretations of terms such as 'stagnant' and 'homogeneous' – the very thing that the move away from 'structural links' has been welcomed as avoiding.

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