



Tetra Laval/Sidel: The limits of leverage in EC mergers

The Commission decision in *Tetra Laval/Sidel*, overturned by the CFI, was potentially the most far reaching case of recent years.¹ If the Court had not overturned the decision, the Commission would have had considerable discretion to use its merger control powers to stop successful companies from expanding beyond the markets in which they are currently strong – even when little or no market power is created as a result. The Court has not prevented the Commission opposing future “conglomerate mergers”, but has placed the burden of economic and factual proof firmly on the MTF’s shoulders.

The background

Tetra Laval has been held dominant in its main market (aseptic carton packaging equipment and consumables) and was well aware that its deal was likely to be closely scrutinized. Tetra Laval acquired Sidel², a French company a major producer of PET packaging equipment – in particular Stretch Blow Moulding (SBM) machines which make the PET bottles used to package water and carbonated soft drinks. The SBM machine is only one component of a PET line: filling machines, in which neither Tetra Laval nor Sidel is a leading supplier, are the major parts of a PET line.

The decision by a packager whether to use PET or carton does not depend on relative prices to any appreciable extent. Packaging choice is determined primarily by technical qualities and marketing considerations. The Commission, rightly, found that there were two separate markets, one for carton and the other for PET. Tetra Laval was prepared from the outset to dispose of activities that created some minor overlaps.

The Commission focussed its attention on a few uses where carton and PET might in future become practical alternatives: milk, juices, tea/coffee based drinks and fruit-flavoured drinks, (called the “sensitive segment”). Today, very few of these products are packaged in PET – less than 1% of the markets for milk and juice and figures around 25-30% for the other markets where volumes are very small. Despite these facts, the Commission contended that, although plastic is not used very much today in these applications, it will be used increasingly in the future owing to technological change. Such change would permit better barriers for light and oxygen which currently

significantly limit the use of PET for milk and juice. The Commission foresaw within the next five years a prodigious increase in PET usage at the expense of carton for these end-uses.

The Commission’s theories

The Commission advanced two principal theories of anti-competitive harm.

Elimination of Potential Competition

The Commission found that substitution between carton and PET, though too weak to be in the same market, was still significant enough to strengthen dominance in carton following the elimination of the purported constraint exerted by Sidel. It reasoned that post-merger Tetra Laval would strengthen its aseptic carton position since any future substitution to plastic would be substitution to its own sister company (i.e. Sidel). The Court did not accept that the Commission had demonstrated significant or growing competition between carton and PET. As a result, it rejected the potential competition argument.

Leveraging or creation of dominance in PET

The Commission’s leveraging theory was the most significant aspect of the original decision. The Commission’s approach was as follows. Packagers of juice, milk and other “sensitive” products currently primarily use carton. With advances in technology, they will increasingly be adding PET to their product offerings. Thus, in the future, there will be substantial customer overlap. Tetra Laval will offer juice and milk packagers a good deal on future carton purchases if they agree to buy SBM machines from Sidel. The claim was that this would *shift demand* from rival SBM producers. Under the Commission’s theory, the payoff to Tetra/Sidel post merger would be reduced competition in the supply of SBM machines to the sensitive segment. By marginalising rivals, Tetra would be able to enjoy higher prices in this sector in the long run.

For its concern to have much plausibility the Commission needed to find that sales of SBM machines to packagers in the sensitive segment constituted a distinct market, separate from sales to other end uses such as carbonated soft drinks and water. Tetra Laval contended that even if it could discriminate by end use on the demand side (which it denied) it still could not exploit any market power even with 100% of the sensitive segment. This is because on the supply side little, if any, extra investment or technology was needed to serve the sensitive segment. Any rival serving carbonated soft drink and

¹ Lexecon Ltd acted as economic advisors to Tetra Laval during the original case and throughout the appeal.

² Under the rules of the French stock exchange, the acquisition could not be conditional on antitrust approval.

water users (which are and will remain the major uses of PET) could equally well serve the sensitive segment.³ Hence, any attempt to marginalise or foreclose competitors by shifting demand in the sensitive segments could not be profitable.

The Court held that the factual evidence was against the Commission's approach in the decision, which on this point had contained no relevant evidence – special investments are needed, if at all, only in filling machines (in which Sidel is not a major player) not in SBM machines, which are generic across segments and interoperate with all filling equipment.

The role of leverage theories

The Court's approach confirms that leverage theories can have a role to play in merger cases. The economics of leveraging focuses on the motivation that a firm has to extend its monopoly power in one market to an adjacent market. In principle it could accomplish this in several ways such as bundling products together through price discounts or through technological ties.

But the fact that a firm has an ability to leverage does not mean it will have the *incentive* to do so. Leverage theories were once popular with the US authorities (particularly in the 1960s and 1970s) but this popularity later waned, reflecting an intellectual shift in economics which stressed that often it will *not be profitable* for a firm to attempt to extend a strong position in one market to another. Chicago school economists, in particular, argued that monopolists could often achieve higher overall profits by maximising their profits in their monopoly market rather than by seeking to monopolise a second market through bundling or tying ("the one monopoly profit theory").

The consensus in economics has again moved on over the past 15 years to pin-point more precisely the characteristics of firms and industries where leveraging may be profitable. Simple generalisations of the results of this large literature are not possible: incentives for leveraging depend on the specific characteristics of the market in question. There is certainly no presumption that firms, if able, will always find it commercially attractive to pursue a leverage policy. There is often a trade-off between the profits that are lost in the "monopoly" market (by engaging in a practice such as tying which will be contrary to the preferences of some customers) and any increase in profits that might be achievable by reducing competition in the secondary market.

Predicting leverage post-merger

The complexity of the modern economic consensus on bundling raises an important question for merger control. When assessing conglomerate mergers, is it enough for the authorities simply to consider whether leverage is made *possible* by the merger? The CFI

has answered "no". The Commission must, show that the circumstances for profitable leveraging are actually to be found in the market under review. The Court examined the methods and impacts of several leveraging strategies and concluded that none of them would be sufficiently profitable. Moreover, the Court made clear that the Commission has to undertake a detailed, fact-based market-by-market assessment of the foreseeable effects of leveraging before it can block a merger on these grounds.

The CFI also emphasised that the Commission did not take into account the importance of alternative *ex post* remedies (e.g. Article 82) and behavioural commitments in reducing the risk that anti-competitive leveraging will result from a merger. Blocking a merger on the basis of the *possibility* of bundling is inherently more difficult and speculative than prosecuting a firm after bundling and leveraging has already occurred in the market place. The CFI has thus set a high bar for the Commission to clear in prohibiting mergers on the basis of leverage concerns.

The implications for future deals

After several high-profile "conglomerate effects" merger cases – culminating in GE/Honeywell⁴ and Tetra Laval/Sidel – it seemed that any merger which brought together products sold to the same customers, coupled with a strong pre-merger position in one of the markets, might be enough to raise serious concerns. This would have been bad news for many large companies wishing to expand their activities into neighbouring or related markets. A company's most promising means of expansion with the lowest risk of disappointment is to use their existing knowledge and skills in a neighbouring market. It would also have been bad news from a public policy perspective: economics tells us that there can be no automatic presumption against this type of merger. Against this background, the clarification provided by the CFI is timely and important.

The Court made clear that competitive harm flowing from conglomerate mergers is inherently more difficult to predict than in the case of "conventional" horizontal mergers, and that particularly robust economic and factual analysis is required if any adverse conclusion is to be reached in such cases. This is entirely in line with the modern economic consensus on the subject. It would be wrong to think that leverage theories have been discredited, but it is certainly true that they must be handled with care in competition policy applications – and never more so than in merger control.

November 2002

© Charles River Associates (published originally by Lexecon Ltd, prior to the acquisition of Lexecon by Charles River Associates)

³ Demand conditions and the degree of competition in the market for SBM machines were also relevant factors for the assessment of leveraging.

⁴ For a full discussion of the GE/Honeywell case, see the Lexecon Competition Memos of August and October 2001.