ICN Mergers Workshop 2018

Nuts and bolts of vertical merger review

Nuts and bolts of vertical mergers

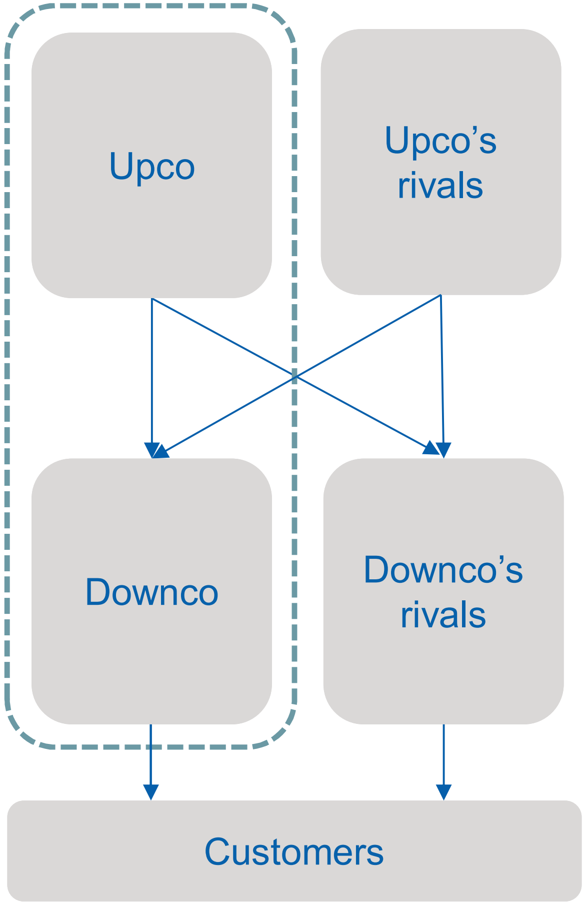
- Introduction to vertical theories of harm and main concepts
- Essilor/Luxottica: example of basic analysis of vertical theories of harm
- UTC/Goodrich: example of more complex analysis with ability, incentives and effects framework

Why competition agencies may investigate vertical mergers

- Vertical mergers do not involve a direct loss of competition between firms in the same market (like horizontal mergers).
- They also have the **potential to create efficiencies** such as reduced production and internal organisational costs.
- So why look at them?
  - Some vertical mergers can weaken rivalry, leading to anticompetitive effects as a result of **foreclosure of competitors** (when the merged firm uses its existing market power in one market to increase its market power in another linked market).

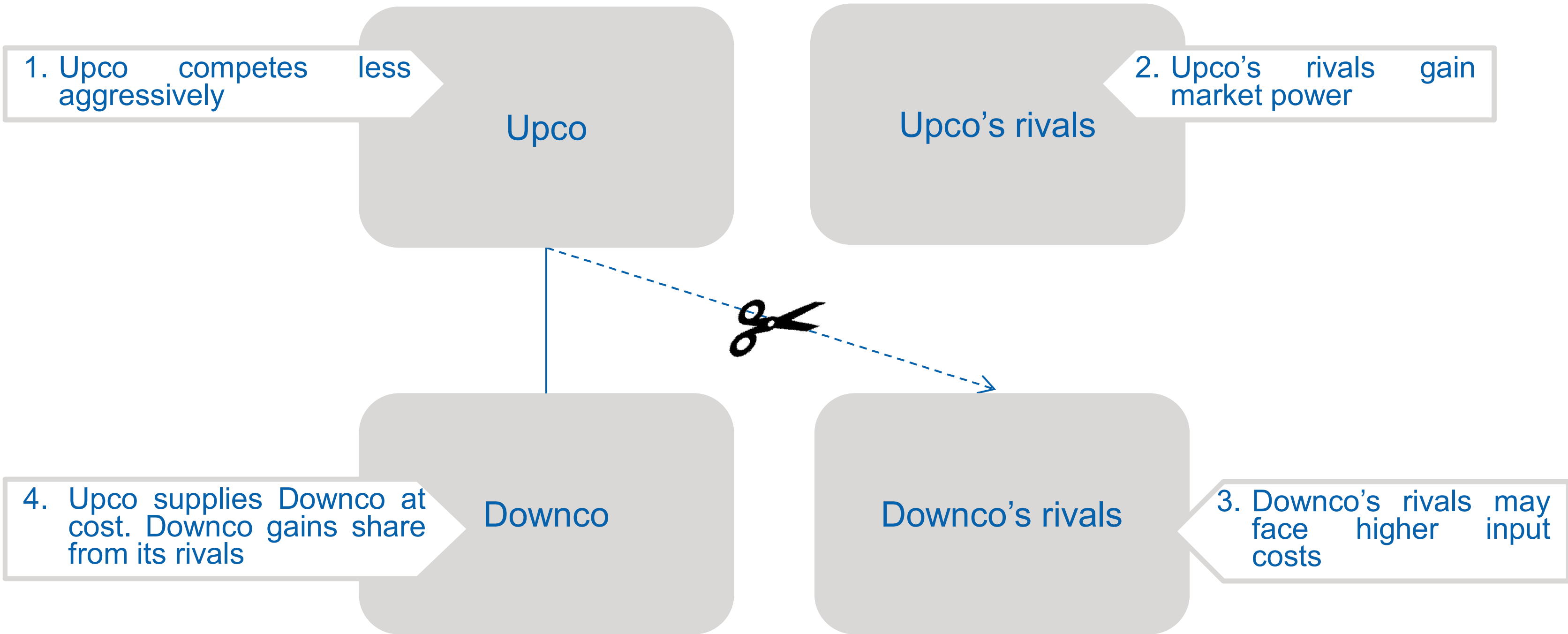
Background to vertical mergers

- Vertical mergers are between firms at different levels of the supply chain.



What are the main theories of harm?

Input foreclosure



The final price is determined by the relative strengths of efficiency and cost raising effects

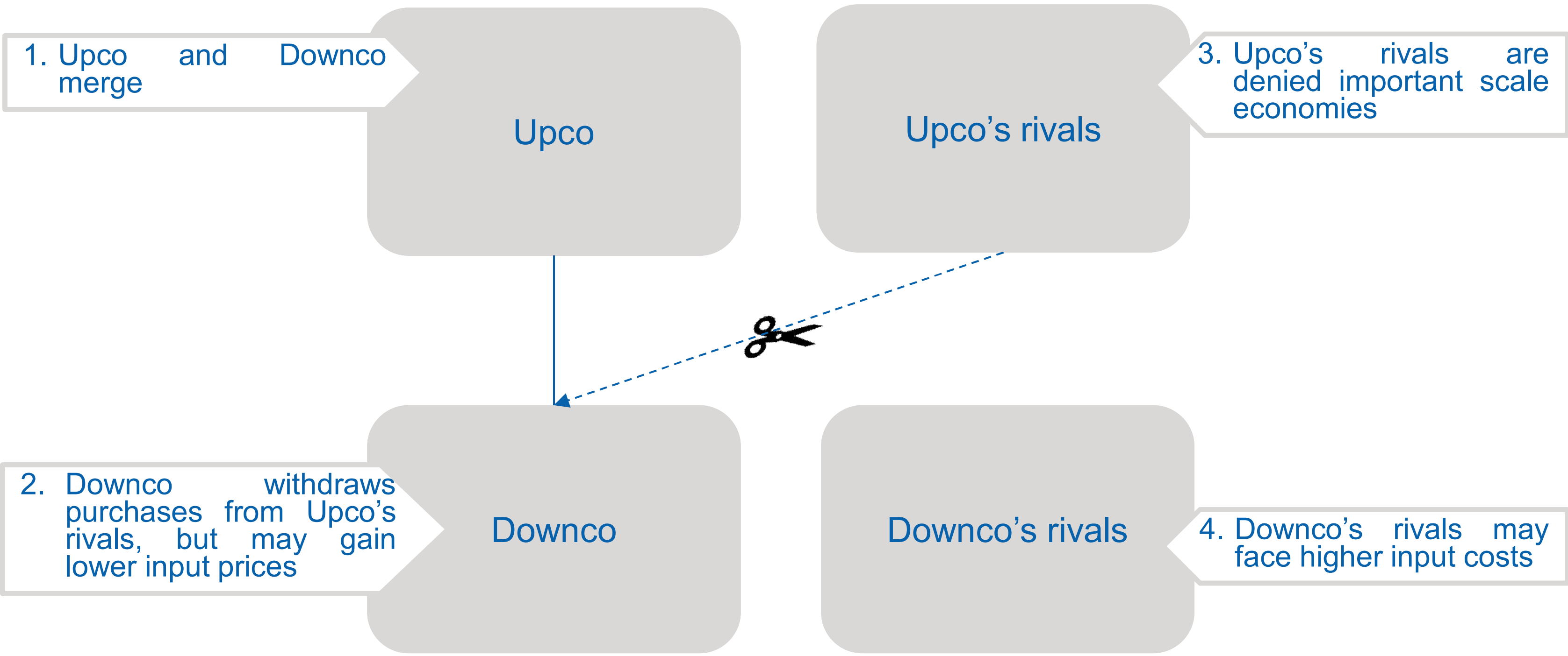
Consider **Ability, Incentive**, to foreclose and whether **Effect** is Detrimental to customers

Source: Parker and Majumdar (2016)

Competition & Markets Authority

What are the main theories of harm?

Customer foreclosure



The final price is determined by the relative strengths of efficiency and cost raising effects

Consider **Ability, Incentive**, to foreclose and whether **Effect** is Detrimental to customers

Source: Parker and Majumdar (2016)

The role of efficiencies

- Vertical mergers have the potential to create efficiencies due to the complementary nature of the upstream and downstream products or services.
- The key types of efficiencies include:
  - Removal of double marginalisation
    - A vertical merger allows the merged entity to internalise any pre-existing double mark-ups
  - Improved coordination between upstream and downstream
    - Mitigation of the hold up problem
    - Elimination of free riding
    - Other coordination efficiencies e.g. manufacturers can share information regarding market conditions and promotional plans
- To overcome any adverse outcomes, these efficiencies will need to be passed on to customers.

Essilor/ Luxottica

Parties – Essilor

- Publicly-listed, headquartered in France
- Active in the manufacture and wholesale distribution of ophthalmic lenses, as well as optical instruments, machines and consumables for eye-care professionals and lens manufacturers
- Also active in the manufacture and sale of some eyewear and online retail sales (10% revenues)
- Worldwide turnover of €7.1bn, EU turnover of €1.8bn.

Parties – Luxottica

- Controlled by a Luxembourg-based holding company (62.549% shareholding).
- Designs, manufacturers and distributes eyewear (prescription frames and sunglasses), which includes brands such as Ray-Ban and Oakley, as well as licensed brands such as Armani, Burberry, Prada.
- Has a retail network focused in the US, with some stores also in Italy (S&V) and the UK (David Clulow). Limited activity in wholesale of lenses.
- Worldwide turnover of €9.1bn, EU turnover of €1.5bn.

The investigation

- **Multijurisdictional investigation:** Australia, Brazil, Canada, Chile, Colombia, EC, India, Japan, Korea, Mexico, Morocco, New Zealand, Russia, S. Africa, Singapore, Taiwan, USA, China and Turkey

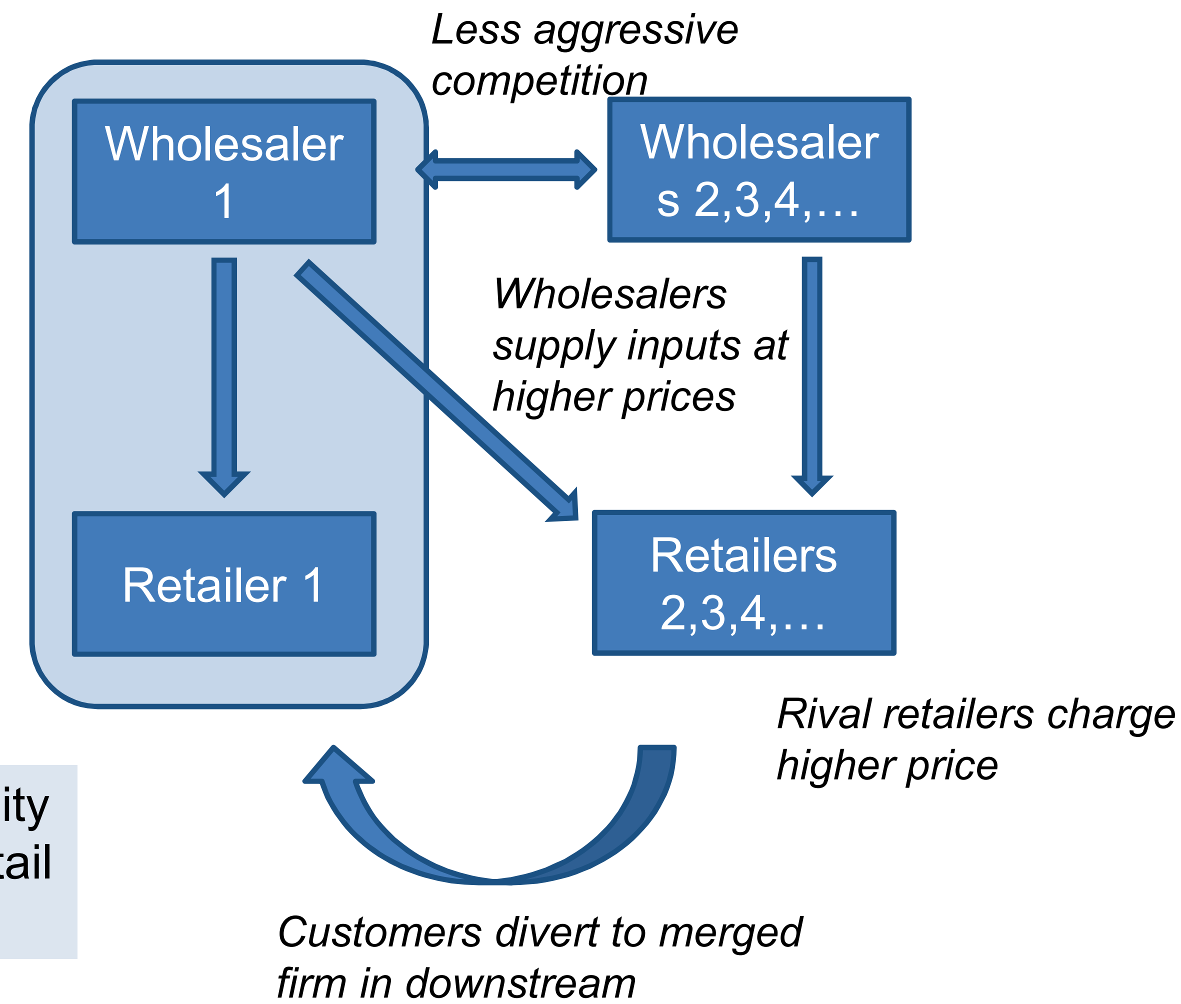
- Transaction raised horizontal, vertical and conglomerate theories of harm

- Vertical theories of harm easily dismissed based on market share analysis and assessment of available alternative suppliers

Commission investigation

Theory of Harm	Product market	Geographic market	Comments
Input and customer foreclosure	Ophthalmic substrate and lenses production	EEA/ National	Sufficient alternative suppliers of ophthalmic substrate Luxottica low share in lenses
Input and customer foreclosure	Ophthalmic machines and lenses production	EEA/ Worldwide	Sufficient alternative suppliers of ophthalmic machines and consumables Luxottica low share in lenses
Input foreclosure	Raw material/ frames and sunglasses/plano lenses	EEA	Essilor low share in sun plano lenses Existence of sufficient alternative suppliers
Customers foreclosure	Ophthalmic lenses and retail activities	National	Luxottica has limited optical retail activities Sufficient alternative lens suppliers
Customer foreclosure	Ophthalmic machines and retail activities	EEA/ National	Luxottica has limited optical retail activities
Input and customers foreclosure	Frames and sunglasses and retail activities	EEA/ National	Luxottica market leader for the supply of frames and sunglasses to downstream optical retailers Essilor has limited online only retail activities

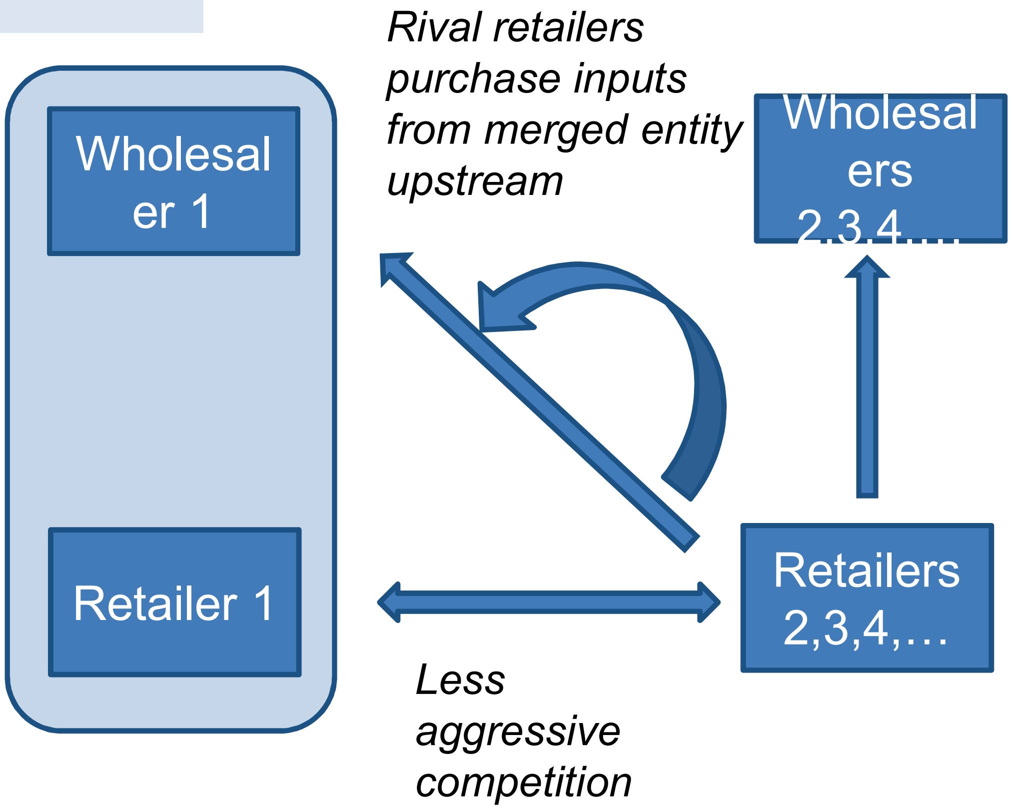
Framework used by CCB in the assessment of vertical TOH



Merged firm has ability to earn additional retail margin

Framework used by CCB in the assessment of vertical TOH

Merged firm has ability to earn additional wholesale margin



Key Observations

- Insignificant market share of Luxottica
- Import driven market
- Absence of regulatory and technological entry barriers
- Availability of sufficient alternatives

Accordingly, CCI unconditionally cleared the transaction

Essilor/Luxottica: Outcome in other jurisdictions

Jurisdiction	Status
Australia	Cleared unconditionally
Brazil	Cleared unconditionally
Chile	Cleared unconditionally
China	Cleared with remedies
Colombia	Cleared unconditionally
India	Cleared unconditionally
Japan	Cleared unconditionally
Korea	Cleared unconditionally
Mexico	Cleared unconditionally
Morocco	Cleared unconditionally
New Zealand	Cleared unconditionally
Russia	Cleared unconditionally
S. Africa	Cleared unconditionally
Singapore	Cleared unconditionally
Taiwan	Cleared unconditionally
Turkey	Cleared with remedies
USA	Cleared unconditionally

UTC/Goodrich

Parties – UTC

- Publicly-listed, headquartered in US
- Active in the production of a broad range of high-technology products and support services for the building systems and aerospace industries worldwide
- Worldwide revenue of €42.9bn in 2011

Baker McKenzie.

Parties – Goodrich

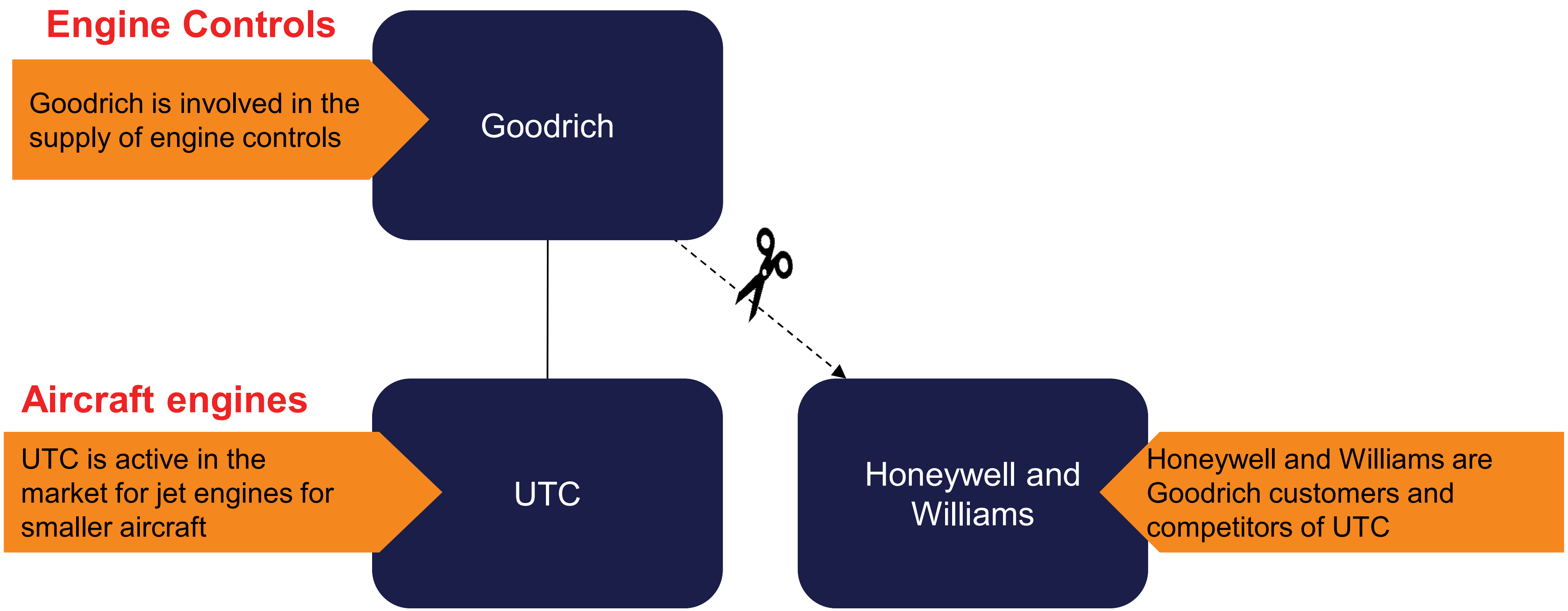
- Publicly-listed, headquartered in US
- Active in the production and sale of systems and services to the aerospace, defence and security industries on a worldwide basis
- Worldwide revenue of €5.2bn in 2011

The investigation

- **Multijurisdictional investigation: Canada, China, EU, US**
- Transaction raised horizontal and vertical theories of harm.
- Vertical theories of harm were one of the main focuses of the case. Remedies were required to address vertical concerns in a variety of jurisdictions.
- There was close cooperation between (at least) the US, EU and Canada.

Engine controls and small aircraft jet engines

Input foreclosure



Engine controls and small aircraft jet engines

Commission concluded that merged entity would have the ability and incentive to foreclose rival jet engine manufacturers and that customers would be negatively impacted

Ability

- Goodrich's customers included UTC's main competitors
- Engine controls were important engine inputs
- Switching to other engine control suppliers would be costly and lengthy

Incentive

- Upstream losses would be compensated by downstream gains
- Merged entity was unlikely to suffer reputational damage from engaging in foreclosure strategies

Effect

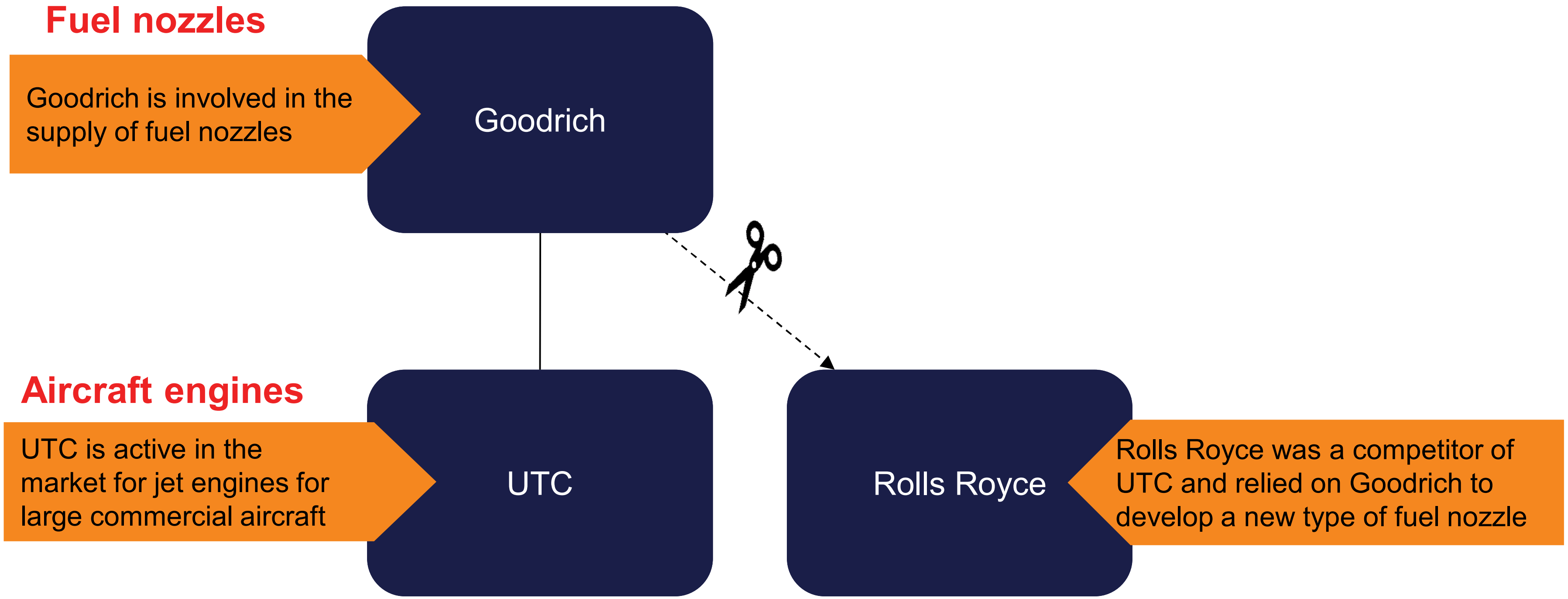
- Potential for reduced choice, increase prices and reduction in quality for customers

Remedy

- Structural remedy imposed: UTC agreed to divest Goodrich's business in engine controls for small aircraft jet engines.

Fuel nozzles and large commercial aircraft jet engines

Input foreclosure



Fuel nozzles and large commercial aircraft jet engines

Commission concluded that merged entity would have the ability and incentive to foreclose Rolls-Royce and that customers would be negatively impacted

Ability

- New fuel nozzle was a crucial input for future large commercial aircraft engines
- Switching to other suppliers would be costly and lengthy
- It would not have been easy for Rolls-Royce to monitor Goodrich's compliance with the contract

Incentive

- Upstream losses would be compensated by downstream gains and by saved costs in relation to the cancelled R&D project
- Merged entity was unlikely to suffer reputational damage from engaging in foreclosure strategies

Effect

- Potential for reduced choice, increased prices and reduction in quality for customers

Remedy

- Contractual arrangement: Rolls-Royce was offered an option to acquire Goodrich's lean-burn fuel nozzle R&D project

Vertical theory of harm considerations

- Ability
  - Market structure
  - Facts of the case

- Incentive
  - Is it profitable?
  - Compare profits from diverted sales, efficiencies, and lost sales from foreclosing

- Effects (likely substantial lessening or prevention of competition)
  - Effective remaining competitors
  - Barriers to entry

- Vertically integrated firm may gain access to competitively sensitive information
  - Consider whether access to information could negatively impact competition

UTC/Goodrich: Outcome in other jurisdictions

Jurisdiction	Outcome
China	**Cleared with remedies:** remedies unconnected with vertical concerns
United States	**Cleared with remedies:** same remedies as in EU

Bayer/Monsanto

भारतीय प्रतिस्पर्धा आयोग
Competition Commission of India
Fair competition For Greater Good

- Acquisition of the complete shareholding of Monsanto by Bayer
- Agrochemicals and seeds business
- Seed industry - Two-stage market

Firstly, development of new variety for each crop *via* breeding (development of parental lines which are crossed to create hybrids) – 'Upstream' and

Secondly, the commercial production and commercialisation of those hybrids – 'Downstream'

Bayer/Monsanto

- Vertical Overlaps

  Upstream market for licensing of Bt. trait for cotton seed

  - Monsanto licensed its two gene Bt. Trait to various seed companies
  - Monsanto had a strong position in Bt. Trait (insect resistance trait) with 97% market share.
  - Other competitors have single gene trait which is less effective against pests
  - Competitors like JK Agri Seeds, Nath Seeds, *etc.* also licenses from Monsanto
  - Bayer was an important potential competitor with two gene insect resistance traits in Cotton

Bayer/Monsanto

भारतीय प्रतिस्पर्धा आयोग
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Downstream market for commercialization of Bt. cotton seed

- Both Monsanto and Bayer were operating in downstream market
- Monsanto also had 26% equity stake in another downstream player

Pending antitrust investigations

- Multiple cases under investigation against Monsanto in relation to abuse of dominant position and anti-competitive agreements (for *e.g.* unfair & discriminatory conditions, excessive pricing, leveraging, *etc.*)

- Monsanto had terminated licensing agreement with few important sub-licensees in the downstream market which could have changed the market dynamics going forward.

Bayer/Monsanto

Input foreclosure

- The downstream seed companies were absolutely dependant on the upstream technology provider *i.e.* Monsanto
- Monsanto had the capability and incentive of excluding competitors in the downstream
- Given that Bayer was one of the potential competitors in the upstream market, the Proposed combination was reinforcing the ability and incentive of combined entity to foreclose the market
- Termination of licensing agreement of many of the major downstream player would also have resulted in significant detrimental effect in the market
- Regulatory approval for GM crop is a time consuming process with time period of 7-9 years. Potential competitor Dow, Metahelix may not be able to enter soon.
- **The Commission concluded that the Parties would be in a strong position to foreclose the upstream market**