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Or. Eng.

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MERGER REVIEW AND MARKET ACCESS

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MERGER REVIEW AND MARKET ACCESS

Types of Mergers and Different Merger Review Objectives Pursued by Competition Agencies

It is useful at the outset to distinguish between vertical, horizontal and conglomerate mergers:

- horizontal merger - combining firms producing actual or potential substitutes
- vertical merger - combining firms that are or could be producing for each other, i.e. they supply goods or services at different points along the chain leading from raw materials to intermediate inputs to finished goods to distribution to the ultimate consumer
- conglomerate mergers - combining firms operating in different lines of business

The market access and competition issues raised by conglomerate mergers are not fundamentally different, although often more tenuous, than those arising in vertical and horizontal mergers. However, particularly in economies characterised by high concentration levels and many conglomerates, there may be concerns about two effects peculiar to a conglomerate merger. First, given the extra difficulties competition offices experience in proving predatory pricing conducted by multiple as opposed to single product firms, conglomerate mergers could facilitate the use of such a pricing strategy. Second, where there is a sufficiently high incidence of conglomerate firms, there could be a tendency for the most efficient firms to avoid low pricing for fear of retaliation in markets where they are at an efficiency disadvantage. Despite these potential concerns, conglomerate mergers are in fact rarely anti-competitive and will not be emphasised in this note.

Most countries apply just one of two different basic tests in merger review. One prohibits or seeks to condition mergers which “create or strengthen a dominant position” while the other takes action against those which “substantially lessen competition”. From the perspective of economic effects, there is little substantive difference between these tests, provided “dominance” is defined as the power to raise and sustain prices above competitive levels, and is extended to include collective or joint dominance. From the legal perspective the two tests could produce different decisions in a given merger, but recent jurisprudential developments seem to be reducing that potential.[1]

It should also be mentioned that there are two general approaches regarding controlling the economic effects of mergers. The first seeks to prevent combinations which will reduce national consumers’ surplus (consumer surplus approach), while the second aims to prevent mergers which will reduce the sum of national consumers’ surplus plus national producers’ surplus (total surplus approach).[2] Neither approach would find a merger to be “anti-competitive” and therefore seek to block it unless it actually or potentially harmed consumers in the domestic market. Such harm, usually in the form of higher prices or reduced output, could arise because the merger either forecloses or otherwise seriously restricts actual or potential competition, or facilitates the substitution of co-operation for competition. Regardless of where the harm originates, anti-competitive mergers can be thought of as combinations tending either to raise prices (consumer surplus approach), or to raise prices without providing sufficient offsetting gains in efficiency (total surplus approach).

In some countries, mergers are reviewed, either initially or at a subsequent higher decision level, under a public interest standard, i.e. consideration is extended beyond pure competition effects in directly affected markets. Such countries might allow an anti-competitive merger because of favourable effects on regional employment, export or import performance, or on positive externalities (including effects on

culture) going beyond directly affected markets. Even if public interest tests accord preponderant weight to pure competition aspects, there seems to be a real risk that they could skew decisions in directions which are neither economically efficient nor neutral as regards market access.

Effects of Trade Liberalisation on Merger Review

There are two main ways in which trade liberalisation has affected merger review. The first is that geographic markets have been widened as national firms face increased competition from firms operating in more than one country. This has apparently created incentives for firms to merge in order to better withstand foreign competition and perhaps even expand operations in foreign markets. Precisely because of greater international competition, such mergers are more likely to be approved by competition agencies than would have been true in the absence of trade liberalisation. Another impact of trade liberalisation has been an increase in transborder mergers, i.e. mergers joining firms whose operations cover more than one nation.[3] Such mergers stand to be investigated by more than one competition agency thus creating the possibility of divergent decisions being taken.

The most obvious reason for divergent merger review decisions is that competition agencies are solely concerned with competitive effects as they affect their own nation's consumers and producers. It could easily happen that transborder mergers have different effects within different national markets. Different decisions could also result from substantive and procedural variations in competition laws. The effect of such differences can be managed but not necessarily eliminated by closer international co-operation among competition agencies.

It could be argued that divergent decisions, whatever their cause, should not create market access problems as long as merger review is applied in a non-discriminatory (by nationality), transparent fashion. It nevertheless remains true that foreign direct investment is both a substitute and a complement of international trade (the complementary aspect shows up in the significant portion of trade conducted between parts of the same enterprise rather than across enterprises). Trade flows could therefore be affected by merger decisions, and where such decisions differ, merger review could give rise to market access problems.

Although merger review could be associated with market access problems, it is also true that merger review has a demonstrated potential to improve market access. This is most notably the case where merger review prevents vertical mergers which could have foreclosed access to a vital raw material or distribution channel. It might also show up when competition agencies insist that merging parties divest certain assets to unrelated parties, which of course would normally include those based in other countries. There have also been instances where competition authorities have required merging parties to use their best efforts to reduce barriers to trade. Foreign firms could therefore have opportunities to enter foreign markets which would not have appeared absent competition agency merger review.

Before considering in greater detail situations where merger review could have an impact on market access, it is worth noting an important problem that both competition and trade authorities need to bear in mind. When a *horizontal or conglomerate* merger is truly anti-competitive, actual and potential competitors of the merging parties, both domestic and foreign, commonly stand to gain in terms of higher prices and increased profits. They can hardly be expected to co-operate in providing useful information that could lead to such a merger being blocked. Conversely, where a merger tends to create a more efficient, effective competitor, rival firms can be expected to provide all kinds of reasons why it should be blocked. It follows that both competition and trade officials should avoid being influenced by unsubstantiated domestic or foreign competitor complaints concerning a proposed horizontal or conglomerate merger. Things are a bit different in the case of vertical merger. It could happen that such a

merger is anti-competitive precisely because it somehow constrains existing or potential competitors, e.g. they lose access to an independently owned input supplier or distributor. This would give competitors an incentive to make trustworthy complaints about such a merger. Unfortunately, they would also have an incentive, although less credible in nature, to oppose a vertical merger which advances consumer interests through improving the merging parties' joint efficiency. (See the Annex for further discussion of vertical mergers.)

Various cases where merger review could be associated with market access problems

1. Cases where mergers would have favourable effects on market access but are blocked because of anti-competitive effects

A firm might find that a merger is the quickest, cheapest or least risky way to obtain or expand market share in a new or existing foreign market. Exporting to that market could be problematic because of tariff or non-tariff barriers including various domestic regulations. In addition, greenfield entry could be significantly less attractive than an acquisition that includes a locally recognised brand name. Although a merger in this situation could facilitate market access it could simultaneously be anti-competitive and be blocked by competition authorities.[4] Admittedly, such a prohibition would reduce at least one firm's market access, but it should not create a market access problem for trade officials provided the merger review was conducted in a way that does not discriminate against foreign firms. However, as the Joint Group has recognised in COM/DAFFE/CLP/TD(98)47/REV2/CORR, trade officials may attach greater significance than the blocking competition authority to the potential for foreign firms to provide a qualitatively different kind of competition than might be available from domestic firms.

Before leaving this case, another possibility needs to be raised. A merger which favourably impacts on market access could be blocked on the basis of non-competition factors contained in a public interest test applied in the course of merger review. More will be said below about potential problems with public interest tests.

2. Cases where mergers have unfavourable effects on market access but are not anti-competitive, hence not blocked by competition agencies

It is difficult to imagine realistic examples where a merger has significant unfavourable effects on market access and does not at the same time substantially raise barriers to entry. It is similarly difficult to understand how barriers to entry might be substantially raised and a merger not be found to have significant anti-competitive effects. This does not mean that such cases could never arise, and vertical mergers might be the most fruitful area to explore in this regard (see the Annex for some further notes about vertical mergers).

3. Cases where mergers are permitted even though they raise prices or facilitate anti-competitive behaviour and also harm market access

In theory, such cases could arise under a number of different conditions three of which are described below. Before examining any of them it must be pointed out that although a merger cannot be anti-competitive if barriers to entry are sufficiently low, an anti-competitive merger does not necessarily involve an *increase* in barriers to entry or somehow *reduce* market access. In addition, where barriers to entry and market access are unaffected by an anti-competitive merger, there are only two reasons why a particular foreign or domestic firm not party to the merger would not expand its sales. Such a firm must either be capacity constrained or choosing to co-operate with other leading firms in their endeavour to raise prices and profits.

a. where countries formally or informally apply a public interest test so as to approve or block a merger for reasons extending beyond pure competition concerns

Some of the extra-competition factors that could be considered include the effects of a merger on employment, regional development, innovation, culture, or export promotion and import substitution. Sometimes these factors are considered in the rubric of a policy to create national champions able not only to withstand growing foreign competition but even to expand shares of foreign markets. The problem with a public interest test is that it can be used for protectionist purposes, or otherwise favour one or more firms over their rivals. This is especially true if the merger review process, or certain phases of it are carried on in a non-transparent manner.

Countries which do not have a formal public interest test are not *ipso facto* immune from the danger of protectionist tendencies creeping into merger review. Some competition statutes require their agencies to take special account of effects on exports and imports when a merger is being evaluated in terms of its possible anti-competitive effects. It is not immediately clear what is intended by such provisions.

b. where a country following a total surplus approach to merger review determines that a merger reduces national consumers' surplus by less than it increases national producers' surplus

This is the case where a merger creates or strengthens an oligopoly market structure, and simultaneously, results in lower unit costs. The lower unit costs could, in certain oligopoly contexts, tend to discourage entry (and reduce market access) despite the post-merger higher price.

Although in theory the application of a total surplus approach could produce the described results, the important point to note here is that not all countries apply a total surplus approach and those who do appear to approve very few mergers which would not have passed muster under a straight consumer surplus standard.

c. where the costs and benefits of a merger are unevenly distributed across jurisdictions

It could happen that all or most of the benefits of a merger are concentrated within the jurisdictions most able to block it while the reverse is true for all or most of the costs. All countries having competition agencies empower them only to protect national interests. This creates a potential difficulty whenever the distribution of a merger's costs and benefits varies across jurisdictions. This problem is not solved simply by the fact that virtually all countries with competition laws claim jurisdiction over mergers harming competition in their country. Such jurisdiction does not automatically translate into an actual ability to stop a merger. Suppose Country A's consumers will be harmed by a merger but Country A accounts for little of a merged entity's world-wide assets or sales. In such a situation, Country A's competition officials may find it very difficult to obtain information essential to determining the possible effects of the merger. Even if the information problems are solved, and they might be through increasing international co-operation among competition agencies, a more difficult issue arises at the remedy stage. If Country A's competition authorities tried to stop a highly profitable merger, the result could simply be that the merging parties decide to pull out of Country A rather than risk legal measures taken to collect fines. Such an eventuality would be a pyrrhic victory for Country A's competition office. Country A would effectively lose the competitive presence of both rather than just one of the two former suppliers.

Some Additional Empirical Questions and Related Policy Issues

Should the Joint Group wish to return to this topic in the future, there are a number of empirical issues they might wish to examine:

How frequently do market access problems actually result from merger review decisions and what are their principal causes?

To what extent do market access problems provide reasons for countries to rethink the use of public interest tests in merger review? How might trade and competition agencies work together to reduce market access problems related to the application of public interest tests (e.g. confine merger review to competition factors and/or, ensure greater transparency in merger review)?

What measures could and should be taken to enable adversely affected foreign producers and consumers located in smaller markets to better defend their interests in merger review? For example, should steps be taken to enhance private party rights to petition competition agencies to investigate alleged anti-competitive mergers and/or expand private party rights to challenge mergers in court?

In merger review, should market access trump competition concerns? If so, under what conditions?

What time frame is pertinent in making market access assessments, and how does this compare to the time frame used in estimating anti-competitive effects? Are there any serious problems if these time frames differ and, if so, how might they be resolved?

Annex - Further notes about vertical mergers

Vertical mergers are generally less likely than horizontal mergers to harm competition. Moreover they are at least as likely to produce efficiency gains. The main efficiency rationales for vertical mergers are the same as for vertical restraints, namely: to solve certain market failures such as those arising through double marginalisation (i.e. both firms have market power); to avoid certain negative externalities (i.e. free rider problems); to reduce transaction and co-ordination costs; and to shift risks to the party best able to bear them.

Unfortunately, there are ways in which vertical mergers, again as with vertical restraints, can reduce competition. Anti-competitive effects are particularly likely to occur through the effect of a vertical merger on competitor access to certain inputs or distribution channels, i.e. foreclosure effects. Vertical mergers will, virtually by definition, result in some degree of foreclosure. Whether this renders the merger anti-competitive depends on the post-merger alternatives still remaining to competing firms. The degree of foreclosure resulting from a vertical merger is critical to both competition analysis and to determining the impact of a vertical merger on market access.

While it could certainly happen that foreign firms are harmed by the foreclosure effects of a vertical merger, this does not mean that market access is always advanced by prohibiting vertical mergers. As with domestic firms, foreign firms may find that a vertical merger is the best way to enter a market. Consider for example a case where a distributor must be persuaded to incur product specific investments in order to introduce an imported good into the market. For various reasons, vertical restraints such as exclusive territories may not be sufficient to entice the distributor to undertake the necessary investments. It may also be true that a greenfield investment in distribution would take too long or is infeasible for other reasons. That would leave a vertical merger as the instrument of choice to introduce or expand sales of the imported good.

Notes

1 In jurisdictions where dominance is typically proved with the aid of market share presumptions, one could imagine a merger that fails to trigger those presumptions, yet still substantially lessens competition through what are known as "unilateral effects". Moreover, turning to a merger's potential to enhance anti-competitive co-ordination ("co-ordinated effects"), the manner of actually proving collective or joint dominance could prove critical. If courts or competition officials insist on some kind of structural link in order to find collective dominance, a dominance test could prove to be considerably more permissive than a substantially lessening competition test. The possibility of courts or competition officials doing so, however, has been reduced by recent jurisprudential developments.

2 Consumers' surplus is a measure of consumer welfare and could, in theory, be calculated as the difference between the maximum that consumers would be willing to pay and what they are actually currently paying for the quantity of goods currently consumed. Producers' surplus is roughly equivalent to the amount by which current profits exceed the minimum necessary to ensure continued employment of capital in a given business.

3. The Chairman of the U.S. Federal Trade Commission recently pointed out that: "...at the Federal Trade Commission, 25% of the mergers filed [in 1997] involved parties or assets in at least two different countries and sometimes as many as eight or ten." "Competition Policy in a Global Economy - Today and Tomorrow", remarks by Robert Pitofsky...to the European Institute's Eight Annual Transatlantic Seminar on Trade and Investment, Washington, D.C., November 4, 1998, page 3.

4. It is admittedly unlikely, under the assumed conditions, that a horizontal merger will be simultaneously good for market access yet bad for competition. This is because such a merger would leave the number of actual competitors unchanged. Moreover, a possible reduction in the number of potential competitors seems irrelevant in situations where such competition can be realised only through merger. An exception to the generalisation about horizontal mergers could arise where an acquired firm has been a "maverick" competitor (i.e. a firm that has been an unusually disruptive and competitive influence) and the new owners are expected to tame it.

There is a greater possibility, again under the assumed conditions, for a vertical merger to reduce competition. The most probable way this could, but not necessarily would, happen would be through a reduction in rivals' access to difficult to replace inputs or distribution channels.