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Executive Summary of the roundtable on Vertical mergers in the technology, media and telecom sector

Annex to the Summary Record of the 131st meeting of the Competition Committee held on 5-7 June 2019

7 June 2019

This Executive Summary by the OECD Secretariat contains the key findings from the roundtable on Vertical mergers in the technology, media and telecom sector held during the meeting of the OECD Competition Committee on 5-7 June 2019.

More documentation related to this discussion can be found at http://www.oecd.org/daf/competition/vertical-mergers-in-the-technology-media-and-telecom-sector.htm

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Executive Summary of the Roundtable on Vertical mergers in the technology, media and telecom sector

By the Secretariat*

From the discussion at the roundtable held by Competition Committee on 7 June 2019, the delegates' submissions, the panellists' presentations and the Secretariat's background paper, several points emerged:

1. Most vertical mergers are efficient, however where dominant firms are involved there are often concerns over the impact on competition. These concerns are typically examined using an ability and incentive framework to understand whether it is profitable for the merged firm to foreclose rivals. In media markets, upstream firms often negotiate prices with downstream firms, meaning that agencies need to use bargaining models to understand the likely effects of a merger on prices. The presumption in such cases is that profit-making firms are likely to act on opportunities to maximise profit.

It is widely recognised that vertical mergers are rarely anti-competitive, however there is also agreement that they can harm competition and many examples of vertical mergers that were expected to harm competition and consumers were cited during the discussion. These reflected agencies concerns that the merging parties, who were already dominant in either the up or downstream market, would have both the ability and incentive to totally foreclose competitors by denying them access to an input or to customers, or to raise the costs of rivals and partially foreclose by increasing price or reducing quality of an input. For this reason, some experts have argued that agencies should not presume that mergers in oligopoly markets are pro-competitive. In the media sector the risk is often that by vertically integrating, a firm will acquire an incentive to use its market power in content to reduce horizontal competition in distribution (input foreclosure), or its market power in distribution to reduce horizontal competition in content (customer foreclosure).

Agencies typically use an ability and incentive framework to analyse these concerns. In an input foreclosure case, this firstly identifies the degree to which firstly partial or total foreclosure of an input would lead to downstream rivals losing sales. Secondly, the degree to which the merged firm's downstream subsidiary would benefit, either by gaining sales or by being able to increase prices. Then thirdly, given these effects, whether the merged firm's upstream business would lose too many sales to make such a strategy profitable. Where rivals can easily and inexpensively substitute away from the merged firm's input there will be little incentive to foreclose. However, upstream rivals might themselves follow the merged firm in raising upstream prices, or may reposition their products and this may also affect the incentive to foreclose.

In media markets, upstream firms often cannot simply set a list price (or quantity), instead they negotiate prices with downstream buyers. If a temporary lack of agreement (or blackout) would benefit the merged firm's downstream business then the merger would increase the bargaining leverage of the merged firm in its negotiations and hence allows it

* This Executive Summary does not necessarily represent the consensus view of the Competition Committee. It does, however, encapsulate key points from the discussion at the session, the delegates' written submissions, the panellists' presentations and the Secretariat's issues paper.

to negotiate a higher price. Notably this increase in price relies on the credibility of the threat of a blackout, and does not require that the threat actually be carried out. Disruptions to supply are therefore likely to be extremely rare. Once the increase in rivals' costs has been calculated, the pass-through to consumers can be assessed.

Underlying each of these concerns is a presumption that profit-making firms are likely to act on opportunities to maximise profits. If this presumption were to be challenged, it would be important to understand the alternative objective for the firm that is thought to replace it. This would then allow the effects to be predicted using an ability-incentive framework.

2. Vertical mergers can improve efficiency and reduce prices by eliminating double marginalisation (EDM). However, the same effect can have anticompetitive effects where firms sell multiple competing products, therefore agencies need to weigh the impact of EDM, other merger specific efficiencies, and any anticompetitive risk in order to understand the likely effect on price and quality. In doing so agencies should carefully evaluate EDM since research suggests that it is rarer, smaller and less merger specific than is often claimed.

Economic theory suggests that vertical mergers can have an ambiguous effect on price and quality. This is because when firms with market power at different stages of the supply chain merge, they may be able to internalise the fact that setting higher prices upstream reduces their joint profits. This can lead them to set lower downstream prices for consumers in order to increase sales and maximise their joint profits. Given the presumption that profit-making firm are likely to act on opportunities to maximise profits, this means that there will also be downward pressure on prices as a result of a vertical merger between firms with market power in their respective markets.

At the same time, there are examples where EDM had anticompetitive effects when it involved firms with multiple competing products. This is because they increased the price of those products that they were not able to remove double marginalisation in order to steer consumers towards products where there had been EDM. When such concerns arise, or indeed, more traditional concerns over total or partial foreclosure effects, agencies will need to weigh these against evidence of any merger specific efficiencies, including those that arise from the elimination of double marginalisation.

In perhaps as many as half of cases, upstream businesses do not ship to their downstream subsidiaries and so there is no scope for EDM. In many of the remaining cases EDM is often not merger specific where vertical restraints such as maximum RPM enable upstream firms to ensure that downstream firms are not setting inefficient retail prices. In addition in those cases where there is EDM, the value is often much smaller than many think. This is because when an input is already widely used by downstream firms, the lower price at the integrated downstream business that EDM makes possible has the effect of cannibalising sales made by other downstream rivals who were already purchasing from the upstream business. This leads experts to conclude that EDM has been overemphasized in theory and practice. For example, the evidence to support its existence and magnitude comes from indirect tests that create scope for confusion between the effect of EDM and the effect of other efficiencies including knowledge transfer and the mitigation of contracting costs.

3. The Technology, Media and Telecom sector, and particularly the media markets within it have many specific features that agencies need to be aware of when assessing a vertical merger and so it is often important to cooperate with the sector regulator. For example, important recent developments include the growth of over-the-top

(OTT) broadcasters. However, a detailed case-by-case assessment is required to understand whether such developments effect the likely impact of the merger.

Merger activity in the TMT sector is significant, accounting for 24% of merger activity and 16% of the mergers that required intervention in 2017. The sector and particularly the media markets within it are characterised by a host of specific features and broader public policy objectives that agencies may need to be aware of when assessing a vertical merger. Public interest tests designed to guard the plurality of news outlets rather than the efficiency of the market often apply. Many countries have a public service broadcaster with an obligation to resolve various market failures (for which they are remunerated through public spending or as a ring-fenced mandated fee). Furthermore, these markets are often highly regulated, with broadcasting licences required; spectrum auctioned by government; and regulated access to electronic programme guides. All of which creates the need for close cooperation with sector regulators.

Particularly important recent developments in the sector include the emergence of over-the-top (OTT) services that provide television services over the internet to handheld devices and tablets as well as more traditional hardware. This has shifted the consumption habits of many consumers away from linear consumption (at the time of broadcast) and towards on-demand consumption, e.g. viewing at a time of the users choosing. The development of these services is happening at different speeds in different countries and acting to prevent the concentration of content (for example by blocking the creation of national champions such as Project Kangaroo in the UK) is likely to help increase the speed of new entry and innovation. Indeed, it was noted that traditional incumbents had responded by developing their own OTT services. However, the importance of content remained unchanged and indeed many providers were moving upstream into the production of content increasing the number of vertically integrated competitors.

While agencies were aware of the growth of OTT, it was noted that give the importance of content this did not always affect the analysis. For instance, where valuable content was not available via OTT, there would be little or no diversion ratio from television towards OTT as a result from a vertical merger that increased the price of that content.

4. Where agencies identify harm to competition there are a range of structural and behavioural remedies that are used in different contexts to address the concerns. In the case of behavioural remedies, it is important to ensure that the remedy includes the necessary ancillary measures that are required to monitor and enforce compliance with the remedy. While there are challenges in designing behavioural remedies, effective access remedies can often offer a proportionate solution to agencies concerns and so relatively low cost options such as arbitration are worth considering.

Structural remedies in the technology, media and telecoms sector can include simple prohibition, which eliminates any competition concerns. These in effect create structural separation of the businesses, which can prevent input or customer foreclosure, and hence forestall the need for ex-ante regulation. Alternatives include divestiture, either of tangible assets (e.g. a radio station) or of intangible assets (e.g. intellectual property). However, behavioural remedies are the most common remedy to problematic vertical mergers. These include mandatory licensing (often suggested as a solution to acquisitions of start-ups by large dominant firms), mandating interoperability, and the prohibition of exclusive dealing. Internal firewalls may also be included within a package of behavioural remedies, though these are unlikely to be effective in isolation.

Behavioural remedies often require the introduction of ancillary clauses that give competition authorities the powers to monitor and enforce compliance with the remedy. These can include transparency provisions requiring that the merging entity systematically provide information to the authority about its business conduct; anti-retaliation provisions preventing the merging entity from retaliating against competitors who report anti-competitive conduct to the authority; and arbitration provisions that create an arbitration mechanism in case of disputes about the proper implementation of the remedy. One simple and effective option for providing fair, reasonable and non-discriminatory access without having to specify what “fair and reasonable” is to require (‘baseball style’) final offer arbitration in which the buyer and seller submits a proposed price to the arbitrator. After a final hearing, the arbitrator will choose one without modification. This remedy limits an arbitrator's discretion and gives each party an opportunity and incentive to offer a reasonable proposal to improve the prospects of it being accepted by the arbitrator.

If, however, “fair and reasonable” terms need to be defined and compliance monitored then behavioural remedies can prove difficult, expensive, and time-consuming. For instance while rivals may complain that behavioural commitments are not being met, this requires an investment in verification by agencies since rivals are not disinterested parties in this context. In addition, determining the length of behavioural remedies can be difficult, since the point at which they become unnecessary will depend on when sufficient alternatives to the input (or way of accessing customers) become available. However, some have suggested that behavioural remedies such as mandatory licensing are low risk options in the case of vertical mergers that pose a risk to competition. For instance, they do not detract from the vertically integrated firm’s ability to capture any efficiencies that the merger might create, while at the same time, they prevent foreclosure, and would not require enforcing if there were to be no foreclosure effect.