

**DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS
COMPETITION COMMITTEE**

Vertical mergers in the technology, media and telecom sector – Note by Chile

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More documents 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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1. On June 1, 2017, a new mandatory merger review system came into force in Chile. It is a system that transforms the way in which mergers are reviewed by the Fiscalía Nacional Económica (“FNE”), not only because of its mandatory nature but also because it outlines for the first time the way in which such review must be done in terms of procedure and substantive standard. Before said reform, the FNE reviewed fewer mergers and tended to analyse horizontal mergers for the most part.

2. With the arrival of the new system, all mergers that surpass certain turnover thresholds must be mandatorily filed in the FNE before closing. Legislators made no distinction on that regard with respect to horizontal or non-horizontal mergers, making it clear that either case must be assessed by the FNE.

3. In regulating the way in which such filing must be presented before the FNE, a difference was made regarding the information that is requested to the filing parties, setting a higher standard to access relevant data when faced with vertical mergers. Such standard depends on the identification of an “affected relevant market”, upon which the FNE gains access to a larger bulk of information. For horizontal mergers, relevant markets are deemed “affected” by the transaction when two or more of the merging parties hold together a combined market share that exceeds 20%, while for vertical mergers incumbents must have an individual or combined market share of over 30%. So, while combined market shares of 20% will be sufficient for horizontal mergers to trigger a larger request of information, a 30% market share is needed for vertical mergers.

4. This does not mean, however, that a lesser effort will be put into the assessment of vertical mergers. It only means that the filing in vertical mergers requires, at first, less information to be presented. But, the FNE is required by law to assess both horizontal and non-horizontal mergers to the same extent. And for either type of merger, the only relevant question that guides the FNE’s assessment is whether or not its completion would, in fact, substantively reduce competition in the relevant markets.

5. In accordance with the latter, the FNE has analysed various vertical mergers, and even focused when deemed necessary, on the vertical effects that might arise from horizontal mergers as well. Since June 2017, the FNE has reviewed a total of 98 filings, eleven of which have ended in an approval subject to remedies (one in Phase II, and ten in Phase I investigation). Out of the mergers that have ended in an approval subject to remedies, four were analysed as vertical mergers or included a vertical risk assessment, while one involved some other kind of non-horizontal competition concern. More significantly, the FNE has blocked two mergers since the mandatory merger review system came into effect, one of which involved a vertical risk analysis.

6. When it comes to the substantive legal and economic analysis that the FNE must apply, there are no specific guidelines in order to outline the way in which the assessment must take place, the theories of harm that will be considered or the qualitative and quantitative tools that might be displayed. However, the FNE has closed a series of investigations in decision that are public and provide a clear a thorough guideline as to the way in which the agency is currently addressing this sort of mergers.

7. The FNE typically uses the traditional ability, incentive and effect framework, combining (as in the case of horizontal mergers) qualitative and quantitative evidence in

order to determine the risks that are posed by a given transaction. For the production of quantitative evidence, the agency has usually used vertical arithmetics and the vertical gross upward pricing pressure index (vGUPPI). The goal in assessing a merger has been to create a coherent narrative of the transaction and its projected consequences.

8. Each case has been analysed on its own grounds and merits, paying close attention to the distinctive features of each operation and industry involved. There have, however, been some industries that show special and repetitive features. Such is the case with the strong dynamism of certain markets, such as the technological, media and telecommunication industries. All of these markets tend to show high levels of transformation, especially regarding new ways of consumption (e.g., OTT in the television market, payment of bills via Internet, or even online purchase of products). This has led to an important difficulty in projecting the FNE's analysis to the future, which sometimes means an increased difficulty in the assessment and a need for special care in the way in which the analysis is made. However, in its core, the competition assessment in these markets is still conducted the same way in which the analysis for other markets would be.

1. The AT&T/Time Warner Merger Investigation¹.

9. A good example of the sort of assessment that the FNE performs in examining vertical mergers was the review of the merger between AT&T, Inc. and Time Warner, Inc. The transaction involved Time Warner's acquisition of all of AT&T's shares, resulting in the vertical integration of the former's business in paid-TV provision of contents through its subsidiaries, Turner and HBO, and the latter's business in the downstream market of paid-TV distribution to end-consumers.

10. While the FNE assessed the merger without defining relevant markets in a strict way, and thus proceeding to examine effects directly, an important issue to address regarded the competitive pressure that was exerted by OTT platforms, such as Netflix, in the market of traditional paid television. Numerous studies that were examined by the agency showed that in Chile, currently, such platforms are complementary to traditional paid-TV services, evidence that was also backed by third parties that are present in that market and provided statements throughout the investigation.

11. Regarding the competitive assessment, the main risk that was identified was input foreclosure. Said ability certainly existed for the merged entity, since Time Warner owned important channels for paid-TV distributors. The filing parties, though, argued that their contents were not especially important, basing their allegations on market shares built over rating information. In analysing the market, the FNE arrived to the conclusion that television channels are highly differentiated products, being of central importance for distributors to exhibit a varied selection of contents for the consumer. Additionally, some of Time Warner channels (such as TNT and Cartoon Network) were ultimately found to be especially important for Chilean consumers, and market studies showed that a relevant number of clients would actually leave their cable company if they couldn't provide for such content. Further information was also taken into consideration, assessing -for example- other elements that could affect the merging entity's ability to foreclose access to their channels. Such was the case with contracts that were still in effect and forced the

¹ For the full report (in Spanish) of the FNE's decision: http://www.fne.gob.cl/wp-content/uploads/2018/01/inap1_F81_2017.pdf

merged entity to supply content to downstream rivals for a certain period of time, or important consumer regulation that limited cable companies' capacity to react when faced to such a foreclosure.

12. Regarding incentives, the FNE tried (as is the usual practice) to produce quantifications that could take into account the different costs and benefits that would be associated with an input foreclosure strategy. In order to analyse incentives for a partial foreclosure, the agency used the vGUPPI for the first time, and has kept on using it in further investigations. Prices and margins that were needed for the vGUPPI were obtained with information that was supplied by the merging parties, while diversion ratios and pass-through rates were found in surveys that were presented in the investigation by third parties or estimated using common assumptions for these kind of markets. In the end, after a sensitivity analysis and after careful consideration of the specific characteristics of the markets involved, the FNE concluded that incentives to foreclose after the merger were in fact high, leading to concerns regarding incentives of a total input foreclosure strategy.

13. In order to evaluate incentives of total input foreclosure the FNE used vertical arithmetics, which has traditionally been used in decisions abroad for this kind of industry. The relevant data was mostly the same that was used for the vGUPPI with a few additional information, resulting in evidence suggesting high incentives to favor a strategy of total foreclosure of content to downstream rivals. This information was ultimately contrasted with qualitative evidence, whether it supported the thesis or tempered the results, leading to a coherent conclusion that maintained high incentives to foreclose.

14. In analysing effects, the FNE observed that an input foreclosure strategy would finally result in an increase of entry barriers in the downstream markets, as well as lead to harmful consequences to end-consumers, as they would be likely to face an increase in price or a decrease in quality that could not be impeded by current regulation.

15. As is usual with vertical mergers, efficiencies were also analysed by the FNE for this case. In this sense, current regulation holds that burden of proof for efficiencies lies in the merging parties. So despite the fact that efficiencies could have been plausible for this merger, given the structure of the operation and the characteristics of the relevant markets, the FNE did not consider them in the final decision, as they were not verified, quantified or argued in line with the agency's requirements as stated in the horizontal merger guidelines. However, in other cases were, for example, the elimination of double marginalisation was dully argued and demonstrated, the FNE has considered said efficiency in its competitive assessment, and incorporated it in the respective vGUPPI.

16. The investigation was finally concluded with an approval that was subject to remedies, as offered by the merging parties. At the center of these remedies was the obligation to submit any dispute that could arise in the context of negotiations between Time Warner and any paid-TV distributor, to a baseball-style arbitration. Together with an obligation to grant access and a prohibition to discriminate arbitrarily between downstream competitors, these remedies were found to be adequate, sufficient and proportional to counteract the competitive risks posed by the merger. Though frequent abroad, this was a novel remedy to be approved in Chile at the time, and has been used in other investigations since.

17. Other risks that were analysed in the context of this investigation were customer foreclosure and exchange of commercially sensitive information.

18. Regarding customer foreclosure, in terms of ability, AT&T's importance (through its subsidiary in Chile, DirecTV) could not be disregarded. However, the FNE found that

there were no major incentives in order to favor such a strategy. For example, DirecTV's competitive strength, as shown in several market studies, depended a great deal in the diversity of its channels. So foreclosing upstream rivals and, hence, forgoing important television contents would actually harm the company greatly. Benefits, on the other hand, would be limited, as they could only recapture losses through publicity, which represents a low percentage of the total income for most content providers.

19. An exchange of commercially sensitive information, conversely, could not be discarded. The ability for said exchange was readily identifiable, as it was given by the proposed transaction and was not restricted by any current contract. As qualitative evidence showed, the incentive to make that exchange did also exist, since information of prices that were charged to downstream rivals was deemed strategic in the relevant markets. Lastly, effects were corroborated through statements given by downstream competitors, all of which led to the presentation of additional remedies designed to restrict the flow of information from DirecTV to Time Warner.

2. The Servipag/Banco Santander Investigation²

20. Another case that illustrates the approach that the FNE uses to evaluate vertical mergers in the technology sector is the case involving Servipag and Banco Santander. Servipag is a corporation owned jointly by Banco de Chile and BCI, two of the most important banks in Chile. Servipag was created by these banks to assist them in collecting or making the payment of bills, thus optimising the use of the banks' branch offices. Throughout the years, Servipag consolidated this business model and became the country's main actor in the payment of utilities' bills, with a significant number of branch offices. Due to the massification of the Internet, Servipag started collecting bills using digital platforms and became the main player in the market of online payment of utilities' bills.

21. Banco Santander, the main competitor of Banco de Chile and BCI -since together they account for more of 90% of the banking market- wanted to acquire a stake in Servipag and made a filing before the FNE. The deal that was ultimately subject to a prohibition, due to the horizontal risks identified in the market of online payment of utilities' bills using digital platforms, the horizontal risks identified in the market of payment-buttons, but also due to the identification of vertical risks associated with the transaction, none of which were subject to the proposal of adequate, sufficient and proportional mitigation measures by the parties.

22. To be able to compete in the online payment of utility bills using digital platforms, the FNE found that the most important inputs were payment-buttons. Payment-buttons are hyperlinks that provide access to online payment systems. The most important payment-button is currently Webpay, which has exclusive access to debit and credit cards, and has a market share of over 70%. Webpay is owned by Transbank, a company that is jointly owned by Chilean banks. Banco Santander and the owners of Servipag -Banco de Chile and BCI- accounted for close to 60% of the shares of Transbank.

23. The main risk analysed in this case was, therefore, input foreclosure. Regarding the ability to do so, the importance of payment-buttons for competition in the downstream market was analysed. It was concluded that payment-buttons were a fundamental input and

² For the full report (in Spanish) of the FNE's decision: http://www.fne.gob.cl/wp-content/uploads/2018/07/inproh_F101_2017.pdf.

that the parties (Banco Santander, Banco de Chile and BCI), directly or indirectly, controlled more than 90% of that market. The parties argued that they did not control Transbank so they did not have the ability to execute a strategy of this kind. The latter, because despite having 60% of the shares, Transbank's bylaws stated that each bank can only distribute its votes in a maximum of 2 directors, making the parties able to elect 5 directors at most, which would not allow them to control Transbank. However, the FNE arrived to the conclusion that the parties could, in fact, have a decisive influence on Transbank's business, since on the last Board election they ultimately appointed 6 out of 10 directors and had been appointing the majority of directors in the last 10 years continuously, having no other restrictions in the bylaws or shareholder agreements that could limit the actions of the parties.

24. The FNE also analysed whether the presence of a special regulation for Transbank that sets maximum prices for its services could limit the ability of the parties to execute this strategy. However, Transbank currently sets lower prices for Servipag's rivals in the market of online payment of utilities' bills using digital platforms than those set out by regulation, so there was room to significantly increase prices without breaching the regulation.

25. Regarding the incentives to exercise an input foreclosure strategy, these were analysed using vGUPPIs, which showed that there were strong incentives to increase prices to rivals and strong incentives for those rivals to raise their own prices.

26. Finally, regarding the effects of an input foreclosure strategy, it was considered that this strategy would affect the ability of Servipag's current rivals to compete, diminishing their capacity to exert competitive pressure on Servipag and that this strategy would increase the barriers to entry already existing in the downstream market.

27. Although the parties offered remedies, they did not include any measures aimed at resolving the vertical risks and, in addition, they were considered by the FNE as inadequate to mitigate the existing horizontal risks. Since the parties did not offer adequate, sufficient and proportional remedies, the FNE finally decided to block the deal.