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Monopolisation, Moat Building and Entrenchment Strategies – Note by Brazil

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More documents related to this discussion can be found at www.oecd.org/competition/monopolisation-moat-building-and-entrenchment-strategies.htm

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1. Introduction

1. In 2023, 594 mergers and acquisitions were reported to CADE, and 63 investigations of anticompetitive conduct were launched. CADE seeks to use the most adequate assessment tools for all case reviews. To do so, all units of CADE are attentive to international discussions, but the terminology used by foreign jurisdictions is not always incorporated by the Brazilian case law immediately. Sometimes, there is no need to adopt new concepts. On other occasions, the issues at stake in Brazil are not the same as the ones discussed worldwide.

2. As seen below, there were few times when the Tribunal used the terms *entrenchment* and *economic moats*. Despite that, the ideas underlying these concepts have supported some decisions.

3. The idea of entrenchment derived from the US case law has underpinned some merger reviews. Unlike other jurisdictions, which increased the use of these concepts due to the growing importance and scrutiny of digital markets, it did not happen in Brazil. Nevertheless, there is a higher number of case reviews in which the theory of harm is related to market position entrenchment and economic moat creation.

4. In this work, we initially discuss the concept of entrenchment. Secondly, there are reports of cases in which the term was used in Brazil and the relation between the concept of entrenchment and digital markets. The third section presents the concept of economic moat. It is followed by the final remarks, which relate the two concepts discussed with the Brazilian competition legislation.

2. Entrenchment

5. The term *entrenchment* was created in the context of the US competition law. The first occurrence was in the FTC v. Procter & Gamble Co., 386 U.S. 568 case (1967)[2]. On the occasion, Procter & Gamble (Procter), a "large, diversified manufacturer of household products, acquired in 1957 the assets of Clorox Chemical Co., the leading manufacturer of household liquid bleach, and the only one selling on a national basis" (FTC v. Procter & Gamble Co., 386 U.S. 568 (1967)).

6. The Federal Trade Commission (FTC) assessed that the substitution of Procter & Gamble for Clorox could dissuade new entrants and deter the competitive potential of companies that operated in the same market where Clorox operated previously. Competitors would fear the retaliation mechanisms of a rival that operated in several

[1] This document was written by Tatiana Lima, Deputy Assistant Economist of the Department of Economic Studies of CADE and reviewed by Lílian Marques, CADE Chief Economist. It was translated from Portuguese into English by Italo de Medeiros Parente and Izabel Cristina Medina Brum, in-house translators at the International Unit of CADE.

[2] However, Hellman (1982) considers that the concept (HELLMAN, Lawrence, 1982) emerged two years before in the case FTC v. Consolidated Foods Corp., 380 U.S. 592 (1965). "Entrenchment" Under Section 7 of the Clayton Act: An Approach for Analyzing Conglomerate Mergers. Loyola University Chicago Law Journal, vol. 13, Issue 2.

markets. Moreover, retailers that distributed Clorox products could be induced to grant specific shelf placement because these products were manufactured and commercialised by Procter & Gamble. The brand had a broad product portfolio, and therefore, more bargaining power.

7. The Supreme Court considered the FTC theory of harm as feasible:

> *The anticompetitive effects with which this product extension merger is fraught can easily be seen: (1) the substitution of the powerful acquiring firm for the smaller, but already dominant, firm may substantially reduce the competitive structure of the industry by raising entry barriers and by dissuading the smaller firms from aggressively competing; (2) the acquisition eliminates the potential competition of the acquiring firm.*
>
> *(...) There is every reason to assume that the smaller firms would become more cautious in competing due to their fear of retaliation by Procter. It is probable that Procter would become the price leader, and that oligopoly would become more rigid.*
>
> *The acquisition may also have the tendency of raising the barriers to new entry. (...)Procter would be able to use its volume discounts to advantage in advertising Clorox. Thus, a new entrant would be much more reluctant to face the giant Procter than it would have been to face the smaller Clorox.*
>
> *Possible economics cannot be used as a defense to illegality. Congress was aware that some mergers which lessen competition may also result in economics, but it struck the balance in favor of protecting competition.*
>
> *(...)*
>
> *(...) Few firms would have the temerity to challenge a firm as solidly entrenched as Clorox. Fourth, Procter was found by the Commission to be the most likely entrant. These findings of the Commission were amply supported by the evidence. (FTC v. Procter & Gamble Co., 386 U.S. 568, 1967)*

8. Thus, both the FTC and the Supreme Court assessed that the transaction could result in a dominant position, competitive advantages, or even change the efficiency of companies, which may limit new entries and the competitive potential of firms previously operating in the market. In this context, entrenchment refers to scenarios in which companies present accumulation and strengthening of existing market power to such an extent as to hinder the emergence of new players or competitive capacities. This can be the result of some companies' reactions to protect their market dominance and of the characteristics of the market.

2.1. The term *entrenchment* in Brazil

9. Similarly to its use by the American Supreme Court decision on the FTC v. Procter & Gamble Co. case, the term occurs in the opinion of the Office of the Superintendent General on the Kroton-Estácio merger review, in the education sector (2017). In regard to potential conglomerate anticompetitive effects, CADE proposed a theory of harm, developed by Sullivan and Grimes (2006)[3], based on the size of the buyer. According to the Office of the Superintendent General, the theory of harm of *entrenchment*

[3] SULLIVAN, Lawrence A., GRIMES, Warren S. The Law of Antitrust: An Integrated Handbook. Second Edition. Thomson West: 2006.

> *Assumes that the disparity between companies can harm competition because it favours dominant positions in the market. According to the authors, even if there are efficiency gains, they tend not to be transferred to consumers, but entirely to merging companies as supracompetitive profits. Due to this size difference between companies involved in the transaction and their competitors (current or potential), new entries tend to be discouraged, which prevents the reduction of market concentration (available at Document SEI no. 0298899, in Portuguese only).*

10. During the review, the rapporteur commissioner of the case, Cristiane Alkmin Junqueira Schmidt, recalls the concept even though it is not the main reason for clearing the transaction with restrictions:

> *The **entrenchment** occurs when the leading company (large and financially strong), with no scope expansion (hypothesis), decides to try to corner the market (with harms in the short term or via cross-subsidies) to eliminate competitors with less market power. They will not be able to return to the market due to the high barriers (hypothesis). Beyond that, the barriers (hypothesis) will prevent new entries resulting in market foreclosure. Consequently, the leading company has a great advantage to impose unreasonable or even higher prices than the ones charged before, which leads to an increase in profits. Although this kind of conduct can be found in the economy, within mergers (conglomerate or not), efficiencies as to economies of scale and scope are common. This fact justifies constant price drops. Hence, if there is a price drop after the transaction, it results in an increase of efficiency for consumers. This fact concerns competitors, but it also increases consumer welfare. That's why this argument has been put aside when reviewing mergers and acquisitions. Although it is a possible strategy, it would be defined as anticompetitive practice (available at Document SEI no. 0360385, in Portuguese only).*

11. Commissioner Cristiane Schmidt argues that the concept of entrenchment has been put aside in merger reviews. The Tribunal blocked the transaction following the vote of Commissioner Gilvandro Araújo. Commissioner João Paulo de Resende cited part of the vote aforementioned, which defines entrenchment, in his vote on the Itaú-Ticket case, a merger in the payment card market in 2019. João Paulo de Resende considered that the theory of harm mentioned by Commissioner Cristiane should be applied to this transaction (Document SEI no. 0632440, in Portuguese only), which should be blocked. However, the Tribunal rendered its final decision to unconditionally clear the transaction.

12. Moreover, Commissioner Gustavo Augusto Freitas de Lima used the term in two votes, in 2022 and 2023. In 2022, when reviewing a joint venture of firms in the automotive sector (Catena X) involving manufacturers, suppliers, and technology companies, the commissioner found that the transaction could lead to an entrenchment. In his words, “The transaction could prevent competition in the market, giving rise to new and complex barriers to entry" (Document SEI no. 1164755, in Portuguese only). At the time of the hearing, the Tribunal unanimously cleared the transaction subject to remedies. In 2023, when investigating an agreement between Telefônica and Winity, Commissioner Gustavo Augusto Freitas de Lima used the term to state that it was unlikely to occur (Document SEI no. 1287880, in Portuguese only). Telefônica is a consolidated telecommunications company and Winity is a mobile network operator that was granted a government procurement contract. The Tribunal unconditionally cleared the transaction.

2.2. Entrenchment and Digital Markets

13. With the growth of digital markets, the term *entrenchment* was spread worldwide in expressions such as *entrenched market power*. In the document "A new pro-competition regime for digital markets - Advice of the Digital Markets Taskforce"[4], the UK's Competition & Markets Authority (CMA), defines that a firm has an entrenched market position when it hinders rivals' ability to enter and compete in a market, jeopardising market competition. This is also the result of specific market features like network effects, economies of scale, consumer decision-making, the power of defaults, unequal access to user data, and lack of transparency.

14. The term *entrenchment* and correlates have not been used in merger reviews in the Brazilian digital market. However, the ideas underlying the terms have supported decisions. In the case in which the Brazilian authority granted an interim measure to prevent an online food delivery platform (iFood) from signing exclusivity agreements, the Office of the Superintendent-General assessed that this would favour an ultra-market concentration level. Supposedly, the revenue of this agent was protected by high entry barriers related to network effects of the products, significant economies of scale and scope, personalized services, and increasing competition for ecosystems. According to the expert opinion on the case, "These barriers hamper the expansion of competitors' products, regardless of being technically superior." (Document SEI no. 0875341, in Portuguese only) Although the focus in this case is on entry barriers, there is a clear relationship between the rationale used and the concept of entrenchment.

3. Economic Moat

15. The term *economic moat* is even rarer than *entrenchment* in Brazil. Based on internal research, we were unable to find any use or translation of it (fosso, fosso econômico, or fossa) in the Brazilian competition case law. The term is also used less frequently than *entrenchment* in international competition case law.

16. Its first use is attributed to Warren Buffet[5], a US investor, who is said to have mentioned it at an annual meeting of his investment group (Berkshire Hathaway):

> *What we're trying to do is we're trying to find a business with a wide and long-lasting moat around it, surround -- protecting a terrific economic castle with an honest lord in charge of the castle.*
>
> *What we're trying to find is a business that, for one reason or another -- it can be because it's the low-cost producer in some area, it can be because it has a natural franchise because of surface capabilities, it could be because of its position in the consumers' mind, it can be because of a technological advantage, or any kind of reason at all, that it has this moat around it.*

[4]Available at: https://assets.publishing.service.gov.uk/media/5fce7567e90e07562f98286c/Digital_Taskforce_-_Advice.pdf. Retrieved on 16 April 2024.

[5] Available at: https://finance.yahoo.com/news/warren-buffett-explains-moat-principle-164442359.html?guccounter=1&guce_referrer=aHR0cHM6Ly93d3cuZ29vZ2xlLmNvbS8&guce_referrer_sig=AQAAAN6pd-xIE3_Qr9OZBUQCTXdiJtJ8wtlvUPYx_jTEbZLyvWpdUz6JtcZIMjExDR_KDmmzKqxFEZbLxhNS_Cqox6ioR_ru91cbVAow-hB1TPZLeDiU-ZBNyU8G163drkX7OcDyDh8fdCllzYLBs6GrRnjM3pBWo0rMxiJxzOGH6T_W. Retrieved on 15 April 2024.

17. According to the aforementioned quote, *economic moat* is a metaphor for a situation in which a firm's market position is not likely to be threatened by the competitors' or possible entrants' actions. This is because the company has some competitive advantage, which can be strategically created. Otherwise, it may have originated as a result of market features in which the firm operates. The website Morningstar[6] lists some economic moat sources: network effects; intangible assets such as patents, brands, and licences; cost advantages; switching costs; and efficient scale.

18. Hence, many of these sources were also listed as features of markets in which entrenchment is more likely to occur. The terms are intertwined, but different. We understand that, although economic moats can be facilitated by market conditions, they can occur in any situation. Companies can create strategies to differentiate themselves or consolidate their position in such a way as to create economic moats, even in markets that would not reinforce dominant positions.

19. Furthermore, mergers and acquisitions can be an economic moat source. However, it is more likely to be created by commercial and competitive strategies. Such strategies include investing in product differentiation, creating brands, and developing business relationships with suppliers and distributors. These practices are not necessarily anticompetitive and are to be assessed in a case-by-case manner.

20. As aforementioned, we did not find mentions of the term in CADE's case law or opinions by the Office of the Superintendent-General. Nonetheless, we understand that the idea was implicit in votes on anticompetitive practices. When reviewing the proposal in the investigation of the exclusivity agreement by the online food delivery platform, iFood, Commissioner Victor Oliveira Fernandes considered:

> *Due to this historical trend of market concentration, exclusivity contracts have a strong potential to increase the costs for rivals. It prevents small players and new entrants from obtaining a great number of consumers, which enables the launch of a new platform, especially on a national scale. Although iFood has presented data suggesting strong users' multi-homing behaviour in Brazil, the dynamics of the sector seem to have somehow approached the situation of a competitive bottleneck (Document SEI no. 1190284, in Portuguese only).*

21. It is worth noting that the firm signed a cease and desist agreement with CADE. Thus, the authority did not assess whether the exclusivity contracts characterized anticompetitive practices or not. However, the potential to prevent competitors from launching new applications can be seen as a strategy for creating an economic moat.

4. Final Remarks

22. As demonstrated, the Brazilian competition law does not specifically mention the terms *entrenchment* and *economic moat*. Nevertheless, CADE's decisions may consider company and market features that favour market position entrenchment or create economic moats. This is because the Brazilian competition law establishes that potential or actual effects of practices and mergers and acquisitions are to be considered when reviewing a case. When issuing a decision, the authority can consider if the market position entrenchment or economic moats could give rise to anticompetitive effects. Therefore, the Brazilian antitrust law does not set a legal limit on the analysis.

[6] Available at: https://www.morningstar.com/investing-definitions/economic-moat. Retrieved on 14 April 2024.

23. We observe that there are similarities between theories of harm in different jurisdictions and the way the Brazilian authority reviews cases, even when terminology varies and some terms are not used. As mentioned, the concepts of entrenchment and economic moat have not been frequently used in Brazil by the Administrative Council for Economic Defense (CADE). Nevertheless, this does not mean that there is no concern about entrenched market positions or economic moats.

24. Hence, we presented situations in which the rationale for a decision was based on the possibility of the company creating economic moats or market entrenchment. Lastly, we understand that there is no correlation between the use of these terms and the application of their associated concepts and theories of harm in Brazil.