BIICL

British Institute of International and Comparative Law

11th Annual BIICL Merger Conference

RBB Economics

Linklaters

Tuesday 21 January 2014
09:00 to 16:00

Foundation Universitaire,
Rue d'Egmont 11
1000 Bruxelles

11th Annual BIICL Merger Conference

British Institute of International and Comparative Law

Programme cont…

11:30-12:45 **PANEL 2: Remedies and Efficiencies – What Really Compensates for the Loss of Competition?**

Chair: Simon Pritchard, Linklaters

Concerns about lost competition can, in principle, be resolved by countervailing efficiencies and/or a suitable remedy – but what is the cutting edge in EUMR practice on both fronts?

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Giulio Federico, EU CET, "Economic Issues in Remedies Design" – the role of economics in the evaluation of the prospective remedial effects of merger commitments

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Andrea Lofaro, RBB Economics – Are Efficiencies Making Any Headway in EU cases? A review of UPS/TNT and other recent cases

Greg Werden, US DOJ – Comments from a U.S. Perspective

12:45-13:45 **Lunch**

Are efficiencies making any headway in EU cases? A review of UPS/TNT and other recent cases

11th Annual BIICL Merger Conference (Brussels) - 21 January 2014

Andrea Lofaro

andrea.lofaro@rbbecon.com

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Overview

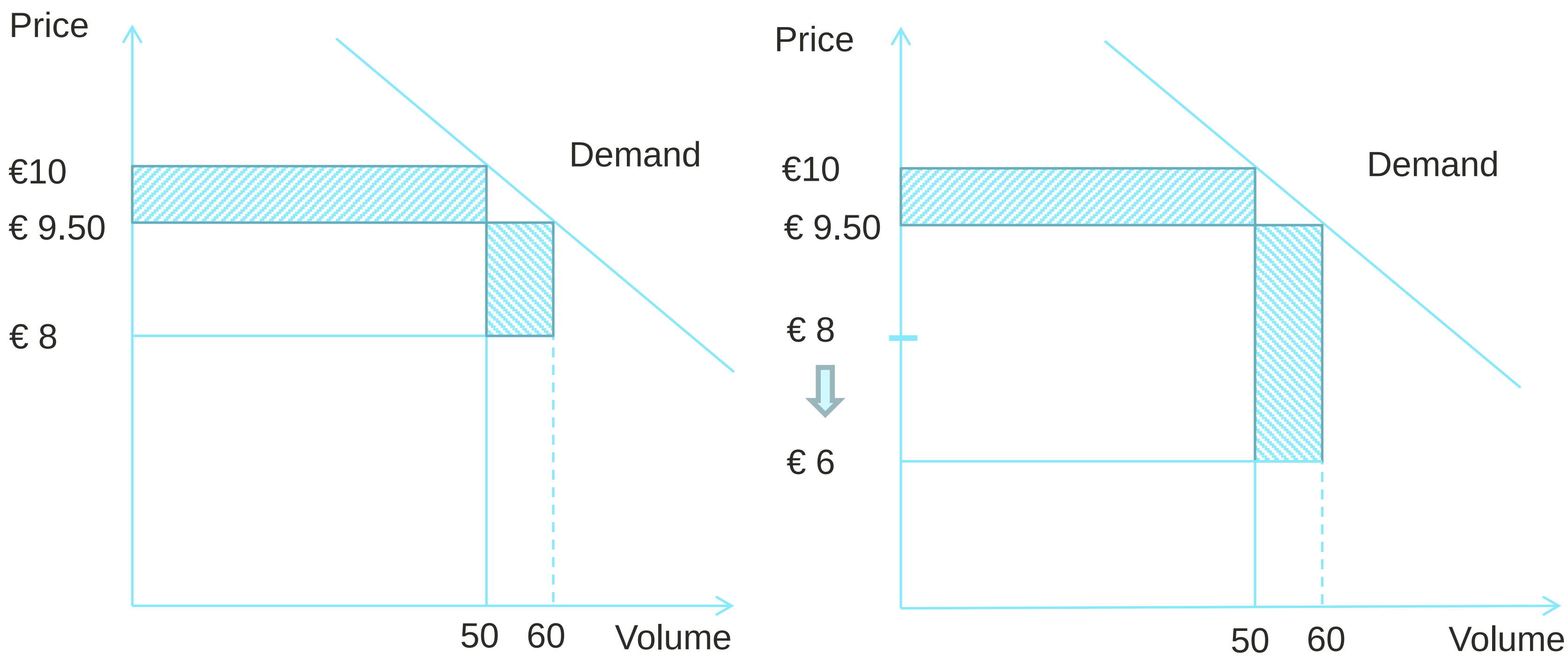
- Traditional obstacles faced by the efficiency defence
  - Efficiency offence arguments
  - Strict efficiency defence test…
  - …that has been applied very stringently by the Commission

- Do recent cases, such as *Deutsche Börse/NYSE* and *UPS/TNT*, signal a change of trend?

- Conclusions

The “Efficiency Defence” (I)

- Profit-maximising firms will often wish to pass on some portion of any cost reduction to customers via lower prices



Profit loss from reducing price: €25 (= €0.50 * 50)

Profit gain from reducing price: €15 (= €1.5 * 10)

Price reduction is NOT profitable

Profit loss from reducing price: €25 (= €0.50 * 50)

Profit gain from reducing price: €35 (= €3.5 * 10)

Price reduction IS profitable

The “Efficiency Defence” (II)

- If a merger leads to a reduction in the merged firm’s marginal costs, this will create a clear incentive to reduce prices that may partly or entirely offset any incentive to raise price
  - E.g., without efficiencies, profit-maximising price would increase from €10 to €11
  - After cost reduction from €8 to €6, optimal price may end up being lower than €10
- As a result, efficiencies can neutralise the adverse effects of a merger
- Traditionally, merging parties have faced extremely tough hurdles when putting forward an efficiency defence
  - “Efficiency offence” arguments
  - A strict efficiency defence test that has been applied stringently

The "Efficiency Offence"

- Increasing the efficiency of the market leader could give that firm such a lead over its rivals that the long-run vitality of competition is endangered
  - E.g. in *Aerospatiale-Alenia/de Havilland*, efficiencies arguments exacerbated the Commission's concerns

- Critics have often argued that the Commission's intentions in such cases amounted to protection of competitors, not competition

- However, much of this criticism is simplistic
  - Concept that dynamic efficiency could be harmed by allowing one firm to gain an unassailable lead is not an unreasonable one

- Complexity of trading off short term benefits with long run anti-competitive effects have led the Commission to abandon "efficiency offence" arguments

A strict efficiency test has been applied stringently (I)

- Each of the following must be demonstrated in order to sustain an efficiency defence:
  - Merger specificity – could the efficiencies be achieved without the merger?
  - Consumer benefit – will the cost reductions affect pricing decisions?
  - Verifiability – are the efficiencies sufficiently certain and substantial?

- Until very recently, the Commission has taken an extremely sceptical and narrow view of efficiencies
- For example, fixed cost savings have traditionally been automatically disregarded (e.g. *Lufthansa/SN Airholding* and *T-Mobile Austria/Tele.ring*)
- However, the distinction between cost savings that will affect pricing and those that will not is far more complex than a simple split between fixed and variable costs

A strict efficiency test has been applied stringently (II)

- Economists must also bear some of the responsibility for placing too much weight on efficiencies
- One root of this problem is the increasing reliance on simplistic theoretical models of unilateral effects, such as the UPP test

UPP_A = Margin (B) × Diversion ratio (A→ B) – Efficiencies (A) × cost (A)

- These models have many drawbacks:
  - Efficiencies are the only antidote to the harmful price effects that are predicted to arise in every horizontal merger
  - Without the efficiency antidote, the policy prescription arising from these simple models becomes alarmingly interventionist

A change of trend?

- Recent cases indicate that efficiencies are now being taken more seriously

- In *Deutsche Börse /NYSE*, the Commission conducted an extremely detailed efficiency analysis
  - It ultimately accepted that customers would directly benefit from having to post less collateral for security
  - However, it concluded that "*any such savings would be insufficient to outweigh the significant harm that would be generated by a merger to near monopoly*"

- In *UPS/TNT*, the Commission abandoned concerns in a number of countries after a detailed assessment, which included an analysis of the efficiencies claimed by the parties

- **What does this case mean for the efficiency defence going forward?**

UPS/TNT: Four-to-three or three-to-two?

- Transaction would have reduced the number of leading suppliers of express delivery services in Europe from 4 to 3



DHL **UPS** **TNT** **FedEx**

- However, due to the lack of density and scale of its network, the Commission determined that FedEx did not exert a significant competitive constraint on UPS and TNT
  - For many EU customers the transaction was effectively a 3-to-2

- Empirical support for the Commission’s concerns was provided by a price concentration analysis submitted by the merging parties themselves

- **Key question: does UPS charge a lower price where it faces a larger number of rivals?**

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UPS/TNT: Price concentration analysis

- Example: pA = €20 - €3*DB + €0.1*DC - €0.2*DD

  where:

  DB=0 if B is not present and DB=1 if B is present

  DC=0 if C is not present and DC=1 if C is present

  DD=0 if D is not present and DD=1 if D is present

- If coefficient associated with DB is statistically significant, then merger between A and B may be expected to give rise to a price increase

- The results of the parties' economists' analysis are summarized in the Commission's press release
  - *"[a significant loss of competition] has been corroborated by the price concentration analysis conducted by UPS. ...This analysis predicted that prices would increase in 29 EEA countries, despite DHL's position as market leader in a number of countries"*
  - *"The Commission performed its own price concentration analysis, which confirmed this outcome but forecasted higher price increases than UPS' model"*

Efficiencies to the rescue? (I)

Commission assessed UPS' efficiency arguments applying the Guidelines' test:

- Efficiencies must be merger-specific
  - Commission accepted that at least some of the efficiencies were unlikely to be achievable other than by the proposed transaction
- Consumers must benefit from the efficiencies
  - Commission concluded that the savings that UPS would make with respect to ground and air transportation would be likely to benefit consumers. However, it found that the overhead costs savings would be unlikely to be passed on
- Efficiencies must be sufficiently certain and substantial
  - Cost savings from ground transportation were dismissed because it was not sufficiently clear that these savings would accrue specifically to express deliveries

Efficiencies to the rescue? (II)

- Only efficiency arguments with respect to air transportation were ultimately accepted

- After calculating the part of these cost savings that would be likely to be passed on to consumers, the Commission found that these efficiencies would not outweigh the price increases caused by the lessening of competition, as predicted by the price concentration analysis

- Commission therefore concluded that the transaction would be likely to give rise to anticompetitive effects in 15 European countries

- In countries where concerns were ultimately dropped, other factors in addition to efficiencies (e.g. FedEx's expansion plans) played a key role

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The remedy

- As a remedy, UPS offered:
  - to divest TNT's subsidiaries in the 15 problematic countries (and in Spain and Portugal too); and
  - to allow the buyer to access its intra-EU air network for five years
- Although this seems like a huge and clear cut remedy, the Commission eventually rejected it
  - Temporary nature of remedy raised questions on what would happen after five years
  - Commission "*had serious doubts as to the ability of the very few potential purchasers that expressed their interest to exercise a sufficient competitive constraint on the merged entity in intra-EEA express delivery markets on the basis of the remedies offered*"

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Conclusions

- Recent cases suggest that the Commission is focusing more on efficiencies than in the past
- However, *UPS/TNT* indicates that merging parties still face extremely tough hurdles when putting forward an efficiency defence
  - Although efficiencies <u>together with other factors</u> led the Commission to dismiss concerns in a number of countries, the efficiency defence ultimately failed [again]
- It seems clear that efficiencies will continue to be highly unlikely to be sufficient *on their own* to overturn a unilateral effect finding
- UPS/TNT case also highlights the increasing role played by economists in the CET at the remedy stage