THE CONTROL OF VERTICAL AND CONGLOMERATE MERGERS BEFORE AND AFTER GE/HONEYWELL –
THE COMMISSION’S DRAFT GUIDELINES FOR NON-HORIZONTAL MERGERS

By Andreas Weitbrecht and Ronan Flanagan *

Non-horizontal mergers, that is, mergers in which the parties are active on different markets, raise competitive issues only in rare instances. In order to offer guidance to companies and their advisors as to what these instances are, the European Commission (the Commission) intends to issue Guidelines for Non-Horizontal Mergers that will complement the Guidelines for Horizontal Mergers issued in 2004. A draft of these guidelines was published for public discussion in February 2007.1 In this article we consider the Draft Guidelines in the context of the treatment of vertical and conglomerate mergers, both in the EU and in the US.

NON-HORIZONTAL MERGERS: THE CONCEPT

In economic terms, companies merge for two principal reasons: to increase their market power and to reap efficiencies.2 It is useful to keep these two parameters in mind when thinking broadly about the effect that different types of mergers have on competition.

Horizontal mergers will, by definition, remove an existing competitor from the market; the market power of the merged entity will be significantly greater than the market power of either of the parties pre-merger. The competitive assessment focuses on the removal of the competitive constraint and the consequent increase in market power enjoyed by the merged entity; efficiencies generated by the merger will only rarely have a significant influence on the outcome.

The competitive impact of a non-horizontal merger will usually be considered either neutral or positive in nature. Vertical mergers will involve the integration of complementary processes, as companies will have been active pre-merger at different levels of the production and/or distri-

* Andreas Weitbrecht is the Managing Partner at the Brussels office of Latham & Watkins LLP. His practices span all areas of German, European and international competition law, in particular merger control and cartel defence. He also teaches competition law at Trier University. Ronan Flanagan is an associate at Latham & Watkins LLP, Brussels. The manuscript was finalized on 9 March 2007. All views expressed in this article are personal to the authors. The authors can be reached at andreas.weitbrecht@lw.com and ronan.flanagan@lw.com respectively.


bution chain. Thus, the merger will often generate increased productive and pricing efficiencies without leading to an increase in market power. A conglomerate merger will involve entities trading in different, but often closely related markets, without a vertical relationship. As a result, the chances of a detrimental competitive impact are even more remote, while efficiencies flowing from so-called “portfolio” or “range” effects (i.e., the ability to offer a broad line of products to the same customer group) will often be generated.

THE EVOLUTION IN THE ANALYSIS OF VERTICAL AND CONGLOMERATE MERGERS IN THE US

It is instructive to view the current economic analysis of vertical and conglomerate mergers in the EU against the historical background of the treatment of such mergers in the US.3 Until the 1970s, merger control in the US was considered to pursue not so much the narrow goal of consumer welfare in economic terms as it is considered today; instead, merger control was thought to be primarily designed to keep “big business” from expanding further and from penetrating markets historically in hands of local operators.

Brown Shoe

In 1962, in Brown Shoe, the US Supreme Court affirmed the prohibition by the District Court of a merger between two vertically integrated shoe manufacturers that would have resulted in market shares of little more than ten percent in some markets both on horizontal and vertical grounds.4 In support of the prohibition on account of the vertical aspects, the Court highlighted the fact that due to the vertical integration of the two companies, the wholesalers of shoes would be losing business and the risk would be that local shoe stores would be pushed aside by the vertically integrated firm.5

Procter & Gamble

As to conglomerate mergers, the Procter & Gamble Supreme Court judgment of 1967 illustrates the thinking at the time.6 The acquired firm, Clorox, was the leading manufacturer in the heavily concentrated household bleach market with a national market share of forty-nine percent. Procter & Gamble (P&G), the acquirer, was at the time a diversified manufacturer of other household products, primarily soaps and detergents; P&G, however, did not produce bleach.

3. EU merger control only began in 1990 with the coming into force of Regulation 4064/89, the first merger control regulation, and therefore has no relevant experience to draw upon prior to 1990.
5. Id. at 333.
The Supreme Court endorsed the view of the FTC that the acquisition might substantially lessen competition in the bleach market, not only because it would eliminate P&G as a potential entrant, but also because the presence of P&G might deter new entrants which would be more reluctant to face the giant P&G than the smaller Clorox.

1982 Merger Guidelines

Over much of the course of the 1970s this analysis was amply criticised by academics. In particular, the Chicago School emphasised that antitrust and competition law should exclusively pursue the goal of allocative efficiency serving consumer welfare. By 1982 the Department of Justice had introduced new merger guidelines suggesting only an extremely limited degree of intervention for vertical and conglomerate mergers, on the basis that such mergers would primarily generate efficiencies to the ultimate benefit of consumers.

EU Commission Practice

Under the EU Merger Control Regulation the Commission has considered numerous vertical and a number of conglomerate cases. The practice of the Commission can be summarized as follows:

Vertical Mergers

In its consideration of vertical effects, the Commission has been wary of the possibility of foreclosing markets to third parties. This concern has arisen in several cases in the telecommunications and media sectors. In Nordic Satellite Distribution, the Commission prohibited the proposed joint venture between Tele Denmark, Norsk Telecom and Kinnevik that would have created an integrated market player active on several levels in broadcast media, ranging from the production of television programmes to the retailing of television sets. Similarly, in sectors where vital technology is developing at pace, the Commission has proved unwilling to permit the position of “gatekeeper” to a vertically integrated company controlling both technology and content. This point may be usefully illustrated through the case of AOL/Time Warner in which the Commission was concerned that the merger of a major media and entertainment company with a pan-European Internet provider could lead to unacceptable “gatekeeper” power in the fast-developing online music sector. This concern

was eventually dealt with by way of commitments offered by the merging parties and the merger was approved.10

Vertical effects have also led to significant hurdles for proposed mergers in the energy sector.11 In the case of ENI/EDP/GDP,12 the Commission prohibited the proposed acquisition of joint control over GDP (the incumbent gas operator in Portugal) by EDP (the incumbent electricity operator in Portugal) and ENI (an Italian energy company). Based on the importance of gas as an input in the generation of electricity, the Commission was concerned that the integration of the dominant gas and electricity operators in Portugal would give rise to foreclosure effects both on the gas and electricity markets. Various remedies offered by the parties proved insufficient to assuage the Commission’s concerns and the prohibition was ultimately upheld on appeal to the European Court of First Instance (CFI).13

Conglomerate Mergers

The Commission has intervened in conglomerate cases in rare instances. In Coca Cola/Carlsberg14 the Commission considered that the breadth of the beverage portfolio of the combined entity would result in greater market power and economies of scale – clear efficiencies stood to be gained but in the light of a pre-existing dominant position, this was not helpful under the “efficiency offence” doctrine. As a result, the Commission extracted as a remedy the divestiture of the merged firm’s interest in a carbonated soft drinks bottling company as well as its interest in the third largest Cola brand in Denmark.

In Guinness/Grand Metropolitan15 the Commission required the merged firm to end an existing distribution agreement for Bacardi Rum in Greece on the grounds that a wide portfolio of leading brands would give the merged firm the possibility of bundling sales and increasing the sales volume of one category by tying it to the sale of another category. Placing distribution of the Bacardi brand in different hands remedied that perceived problem.

EU Court Cases

Where the Commission has primarily or exclusively relied on conglomerate effects to prohibit mergers, its decisions have been appealed and in both cases the Commission’s analysis has been severely criticised by the courts.

Tetra Laval/Sidel

In Tetra Laval/Sidel16 the Commission prohibited the acquisition by Tetra Laval, the dominant player in carton packaging (Tetra Pak), of Sidel, the leading, but not dominant, manufacturer of machines that are used to blow PET bottles. Carton packaging is used primarily for milk and juices, whereas PET bottles are used for carbonated soft drinks and mineral water. The Commission considered that for certain sensitive products that are currently packaged in cartons, PET bottles would over time become a technically and commercially viable alternative. Given that the same groups of customers (bottlers of so-called sensitive products) would then be able to choose between carton packaging and PET bottles, the Commission reasoned that Tetra Laval would “leverage” its dominant position in carton packaging into the market for the machines used to blow PET bottles. This complicated chain of events would then lead to Sidel attaining a dominant position in the market for these machines. The CFI rejected this analysis as too speculative and the Court of Justice affirmed the CFI’s judgment.17

GE/Honeywell

In the celebrated case of General Electric/Honeywell,18 the Commission’s prohibition decision19 was severely criticised as far as the analysis of vertical and conglomerate relationships was concerned. However, the CFI did not annul the prohibition decision as the Court agreed with the Commission’s analysis of the horizontal effects on the markets of engines for large regional jets and corporate jets as well as small marine gas turbines. GE and Honeywell operate on numerous product markets in avionics and non-avionics products for aircraft and Honeywell in particular had a leading position in most of the avionics markets and a very strong presence in almost all non-avionics markets.20

Vertical-Conglomerate Effects21

The Commission had considered that GECAS, the aircraft financing arm of GE, would in the future specify Honeywell equipment in its air-

20. Avionics refers to equipment on an aircraft that is used for flying the aircraft whereas non-avionics equipment refers to other aircraft equipment.
21. The Court also rejected the Commission’s purely vertical concerns as they were based on a pure refusal to deal theory and the Commission had failed to take into account the unlawfulness of that practice under Article 82 EC.
craft purchases, similar to what it had done in the past as regards jet engines for large commercial aircraft (a factor that had contributed to the creation of GE’s dominant position on the engine market). This practice would, according to the Commission, lead to the creation of a dominant position on the markets for Honeywell’s avionics and non-avionics products. The Court held that the Commission had failed to prove the likelihood of such conduct and the likelihood that these practices, if engaged in, would in fact create or strengthen a dominant position in the near future.

_Bundling_

While the above refers to purchasing behaviour, bundling refers to sales practices. It was the concern of the Commission that the broad range of complementary products controlled by the merged entity would lead it to bundle equipment, that is to say, to offer products as a package. While bundling would allow for short-term price reductions it would in the long-term drive out competitors unable to match the package. This would operate to the detriment of consumers. The Court once again highlighted the need for rigorous economic and legal scrutiny in cases relying on the prediction of future conduct. Where there is a dominant position in the market for the tied good, such practices are likely to violate Article 82 EC and the Commission had failed to take into account the illegality of the behaviour when it assumed such bundling behaviour to be likely and sustainable over a longer period of time.22

**Overview of the Draft Guidelines**

The Commission’s difficulty in defending its analysis of vertical conglomerate effects seems to stem from its methodology which was developed in 2001 when both _GE/Honeywell_ and _Tetra Laval/Sidel_ were considered side by side by the Commission. The Commission’s effects-based approach is not founded on structural factors, such as market share or the removal of pre-existing competitive constraints; instead the Commission speculates as to a chain of events, which starts with the assumption that certain behaviour will be adopted by the merged entity. Such behaviour would often violate Article 82 EC and is thus not likely to be adopted or be sustainable over a long period of time. This analysis is inherently complicated and fraught with uncertainties. The Draft Guidelines will only partly remedy that problem.

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22. The Court of Justice, in _Tetra Laval_, supra note 17, had criticized the CFI’s overly broad reliance on the illegality of the conduct, and the Court held that the Commission does not need to analyze in detail the illegality and resulting sanctions under various regimes of enforcement, but the Court of Justice left intact the requirement that the illegality of the conduct must enter into the overall calculus of the likelihood of such conduct occurring.
The Commission positions the Draft Guidelines in parallel to the Horizontal Guidelines \(^{23}\) which they supplement. As regards the treatment of efficiencies, for instance, the Draft Guidelines refer to the discussion contained in the Horizontal Guidelines. The Draft Guidelines define non-horizontal mergers as those where the undertakings concerned are active on distinct relevant markets.\(^{24}\) They recognise that vertical and conglomerate mergers provide substantial scope for efficiencies in that the activities and/or the products of the companies involved are complementary to each other.\(^{25}\)

The Commission also recognises that non-horizontal mergers will only, if at all, create issues where there is pre-existing market power in one or more markets. It proposes a “soft safe harbour” where the market share post-merger of the new entity in each of the markets concerned is below thirty percent and where the post-merger Herfindahl-Hirschman Index (HHI) is below two thousand.\(^{26}\) These figures are placed in square brackets by the Commission which would tend to indicate that they are still under consideration. The Commission nevertheless reserves the right to investigate such mergers where there are special circumstances present that would suggest the likelihood of coordinated effects in one or more of the markets concerned.

The Draft Guidelines discuss coordinated and non-coordinated effects in the context of both vertical and conglomerate mergers. Coordinated effects may arise where the non-horizontal merger will render the market participants on one or more markets structurally more similar, thereby making coordination more likely.\(^{27}\) These are essentially horizontal effects that will not be discussed in the remainder of this paper.

**Vertical Mergers**

Foreclosure in the context of a vertical relationship refers to the shift in demand or supply away from competitors as a result of the merger. Whereas pre-merger the downstream company may have purchased from several suppliers, the merger, having integrated an upstream supplier

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26. Draft Guidelines at paragraph 25. Paragraph 16 of the Guidelines for Horizontal Mergers (supra note 23) notes that “in order to measure concentration levels, the Commission often applies the Herfindahl-Hirschman Index (HHI). The HHI is calculated by summing the squares of the individual market shares of all the firms in the market. The HHI gives proportionately greater weight to the market shares of the larger firms.”
27. Coordinated effects are described at paragraph 19 of the Draft Guidelines as arising “where the merger changes the nature of competition in such a way that firms that previously were not coordinating their behaviour, are now significantly more likely to coordinate and raise prices or otherwise harm effective competition. A merger may also make coordination easier, more stable or more effective for firms, which were coordinating prior to the merger.”
with a downstream former customer may naturally foreclose outside competitors from supplying the downstream business which is now internal to the merged entity. This is often referred to as “customer foreclosure,” a terminology which the Draft Guidelines adopt. The other form of foreclosure, referred to as “input foreclosure,” occurs where the merged entity has the ability to isolate downstream competitors by refusing to supply essential products from the upstream arm of the merged entity to a competitor of its downstream arm. These clear competitive concerns will be most troubling where the market is very concentrated and the number of potential alternative suppliers or customers is limited.

In their consideration of the effects of non-horizontal mergers, the Draft Guidelines pose three principal questions in respect of the relevant future possible conduct:

1. Will the merged entity have the ability to behave in that manner?
2. Will there be an economic incentive for the merged entity to behave in that manner?
3. Will the effect of such behaviour be to give rise to a significant impediment to effective competition?

Foreclosure is considered to be the primary example of a non-coordinated effect. According to the Draft Guidelines, both input and customer foreclosure will be considered in the assessment of vertical mergers under the headings of the three questions set out above. Foreclosure in these circumstances is not considered to require a rival’s exit from the market; a disadvantage leading to less effective competition is said to suffice.28

Where the merging parties have a dominant position in one of the markets concerned, the conduct that the Commission considers in this exercise will violate Article 82 EC. The Commission proposes to consider the impact of Article 82 EC under the incentive prong. While the Draft Guidelines make clear that the possibility of violating EC or national law may be considered to be a feature of the incentive assessment, the extent to which the Commission intends to engage in this appraisal is limited and according to the draft, there is no requirement to enter into a detailed examination of these issues. Moreover, the Draft Guidelines indicate that the impact of this disincentive will turn on the extent to which the violation is clear, the likelihood of detection and the penalties to be imposed upon eventual detection.29 Whether such a relatively limited consideration of the “Article 82 Defence” would be sufficient to stand up to judicial review, remains to be seen.

29. See, for example, Draft Guidelines at paragraph 44.
Conglomerate Mergers

The extent to which conglomerate mergers require any competitive oversight is an issue which has given rise to a considerable divergence of opinion. The Commission highlights the potential for certain foreclosure effects arising out of conglomerate scenarios. This foreclosure may manifest itself through various forms of marketing practices, the most typical examples being “tying” and “bundling.” Both tying and bundling refer to practices by which the consumer may be encouraged or required to purchase a number of goods as a package. These widespread practices do not usually result in particular competitive concerns, but in the words of the Draft Guidelines, in certain circumstances “these practices may lead to a reduction in actual or potential rivals’ ability or incentive to compete.”

In the context of conglomerate mergers, the assessment of foreclosure will look to the extent to which “the combination of products in related markets may confer on the merged entity the ability and incentive to leverage a strong market position from one market to another by means of tying or bundling or other exclusionary practices.” While the Draft Guidelines point out that there is no standard definition of “leveraging,” it is described as the ability “to increase sales of a product in one market [. . .] by virtue of a strong market position of the product to which it is tied or bundled.” As with foreclosure in vertical mergers, leveraging will be considered under the three questions outlined above. With respect to Article 82 EC, the same issues remain.

Conclusion

The public debate over these Draft Guidelines is only about to begin. While the Commission is to be commended for undertaking the difficult exercise of drawing up guidelines for non-horizontal mergers against the background of unfavourable court decisions, a more detailed examination will most likely reveal significant and serious issues that should be remedied in the final version. A more thorough treatment of the “Article 82 Defence” that is in line with the existing jurisprudence on this subject must surely be among the suggestions for improvement.

32. Draft Guidelines at footnote 76.