Vertical mergers

Monika Schnitzer
University of Munich

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Horizontal versus vertical mergers

Horizontal merger

- Internalization of (negative) externalities results in price increase

Vertical merger

- Internalization of (positive) externalities results in price decrease

➢ **A priori strong presumption that vertical mergers are efficiency enhancing**

However

Integrated upstream supplier will also internalize negative externality downstream rivals have on own downstream firm

Incentive to raise rivals cost by raising input prices for downstream competitors

- **Possibility of (partial or total) foreclosure**

This is the main concern in the Sasol/Engen merger

Focus of this presentation

EAGCP Comments on non-horizontal merger guidelines

- Questions relevant to the case

Theoretical paper

- Some tentative answers

Non-horizontal merger guidelines: Ten principles (EAGCP Merger Subgroup)

1. The competitive impact of non-horizontal mergers is fundamentally different from that of horizontal mergers
2. The sources of competitive harm in non-horizontal mergers often require a change in strategy and the impact on competition is indirect
3. There are many forms of non-horizontal merger so there is a large variety of ways in which different (competitive and anti-competitive) effects may occur
4. Market power in an existing market is an essential pre-requisite for competitive harm from foreclosure
5. There are stronger efficiency arguments for non-horizontal mergers than for horizontal mergers

Non-horizontal merger guidelines: Ten principles (EAGCP Merger Subgroup)

6. Non-horizontal merger guidelines could, in principle, enhance the accuracy and predictability of decisions
7. Guidelines should have a clear focus on competitive effects resulting in consumer benefit or harm and not on harm on competitors
8. Guidelines should indicate the methodology of analysis and how evidence can be used to indicate the harm resulting from a non-horizontal merger
9. Guidelines should distinguish “more likely” from “less likely” competitive harms wherever possible
10. Non-horizontal guidelines should be consistent with other Guidelines / Notices / Green Papers.

Issues in the Sasol/Engen Merger

- How likely is foreclosure of downstream competitors?
- How likely is market exit of downstream competitors?
- How likely is it that consumers would be harmed by merger?
- How does this depend on market power in the relevant markets?

Upstream or downstream?
What really matters in vertical integration
(joint with Markus Reisinger)

Focus of the paper

Which market is relatively more relevant for judging anticompetitive impact of vertical merger?

Theoretical Set-up

- m upstream firms
- n downstream firms

- In upstream and in downstream market firms are distributed on Salop circle with equal distance
- Transportation cost t_u and t_d capture degree of product differentiation

Sasol/Engen Case

Upstream market:	80% market share
Downstream market:	40% market share

Consider two upstream scenarios:

1. Sasol-Engen is virtually monopolist on upstream market
2. Sasol-Engen faces competition on upstream market

Scenario 1 – Upstream monopolist
Downstream market with homogeneous goods

Upstream monopolist captures full monopoly profit with or without integration

- No harm to competitors (zero profits anyway)
- No harm to consumers

Scenario 1 – Upstream monopolist
Downstream market with heterogeneous goods

No integration

Upstream monopolist chooses prices such that downstream firms become local monopolists

Integration

Upstream monopolist does not increase prices for rivals, (potentially increased number of sales due to avoiding double marginalization)

- ➢ No harm to competitors
- ➢ Potentially positive effect for consumers

Scenario 2 – Upstream competition

Potential negative impact of vertical integration depends strongly on downstream competition

Number of competitors n

- The larger n, the smaller the incentive to raise rivals' prices, but the larger the negative impact on average prices
- Asymmetric downstream prices distort consumer choices, mostly so for small n

➢ Integration tends to hurt most if n is small

Scenario 2 – Upstream competition

Potential negative impact of vertical integration depends strongly on downstream competition

Product differentiation in downstream market

- Low degree: raising downstream prices is unattractive due to upstream competition
- High degree: raising downstream prices is unattractive due to local monopolies downstream

➢ Potential harm is largest for intermediate product differentiation

Anticompetitive effect of vertical integration strongest if

- Number of downstream sellers is small
- Product differentiation at downstream market is intermediate

Conclusion

- Anticompetitive impact of vertical mergers less easy to establish because it involves predictions about likelihood of future behavior
- What should matter is negative impact on consumers, not on competitors
- Negative impact due to potential foreclosure depends crucially on competitive environment at the downstream market