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New perspectives for vertical merger analysis: challenges in the application of remedies and use of quantitative methods

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In the last few years, vertical merger analysis has gained importance in the antitrust scenario – both in Brazil and in the rest of the world. Although CADE doesn't have a specific guide on the matter yet, ICN's¹ contributions, CADE's² remedies guidelines and the analyses of recent complex cases by the Brazilian agency have contributed to the consolidation of this theme in Brazilian jurisprudence.

The Chicago School's understanding of the effects of vertical mergers have been the longstanding prevailing economic theory in antitrust policy. In general terms, this doctrine considered competitive harm from verticalization would be offset by its efficiency gains. Specifically, by eliminating double marginalization, this kind of merger would have a positive effect on consumer welfare.

Recently, complexities related to the functioning of markets which raised concerns about the possible anticompetitive effects in operations involving vertical mergers were recognized – particularly regarding a broader set of

¹ ICN Merger Guidelines Workbook. Available in: <<http://www.ftc.gov.tw/icnmerger2009/images/ICNMergerGuidelinesWorkbook.pdf>> Last access on 08/16/2019

² CADE, Guia de Remédios Antitruste – Versão Preliminar, 2018. pp.13. Available in: <<http://www.cade.gov.br/aceso-a-informacao/participacao-social-1/contribuicoes-da-sociedade/guia-remedios-antitruste-versao-preliminar.pdf>> Last access on 08/16/2019

deleterious effects associated with the exercise of market power and market failures. According to Motta (2004)³, when the merged company is able to exercise market power and maintain prices at higher levels – that is, when it doesn't pass the efficiencies downstream – vertical mergers are detrimental to consumer welfare. In addition, depending on the market structure, vertical mergers may favor market foreclosure through the increase of entry barriers. If in the past antitrust assessment used to consider vertical mergers to always be pro-competitive, nowadays agencies develop further analysis to verify the net effect of this type of operation.

According to a worldwide research conducted by ICN in 2018⁴, 1 out of 10 mergers analyzed by antitrust authorities corresponded to vertical mergers. In recent years, this proportion seems to have grown in the Brazilian scenario, giving prominence to the theme, especially because of the relevance of the cases being analyzed by CADE. Among them, the merger between Time Warner and AT&T⁵ stands out. It was an international operation regarding the merger of a content provider for subscription television channels (Time Warner Group) and a Pay TV operator (represented by SKY), in the downstream market. The operation was approved in Brazil with remedies aimed at preventing the risk of market foreclosure and the possibility of discrimination against other content providers.

Another case recently judged by CADE was the acquisition, by Petrotemex, of Petroquímica SUAPE and the Companhia Integrada Têxtil de Pernambuco (CITEPE), owned by Petrobrás⁶. In this case, market foreclosure was also identified as a risk, as the supply of PTA resin to the PET resin industry

³ Motta, 2004. Competition Policy. pp. 338

⁴ ICN Vertical Mergers Survey Report.

⁵ Merger of AT&T/Time Warner, nº 08700.001390/2017-14 Available in: <https://sei.cade.gov.br/sei/modulos/pesquisa/md_pesq_processo_exibir.php?0c62g277GvPsZDAXAO1tMiVcL9FcFMR5UuJ6rLqPEJuTUu08mg6wxLt0JzWxCOR9mNcMYP8UAjTVP9dxRfPBcZnHcHjqStvJ5tvzT-q1yr-rThyJwyGjgMQ3PRwTFLfJ>. Last access on 08/15/2019.

⁶ Merger of Petrotemex / Petrobrás nº 08700.004163/2017-32. Available in: <https://sei.cade.gov.br/sei/modulos/pesquisa/md_pesq_processo_exibir.php?0c62g277GvPsZDAXAO1tMiVcL9FcFMR5UuJ6rLqPEJuTUu08mg6wxLt0JzWxCOR9mNcMYP8UAjTVP9dxRfPBcUdx9lnsVvb_ZBGYzi6W0nj6oZVSJ0QXPnijfe11Gq7p> Last access on 08/15/2019.

was considered as essential input. Thus, behavioral remedies were applied to clear the merger.

The trend of using behavioral remedies in vertical mergers is in line with the recommendations of CADE's remedies guidelines and other available surveys, such as ICN's⁷. The concern is that, depending on the case, structural remedies may compromise the efficiencies of the operation, as they usually are contingent on the vertical integration derived by the merger.

In the context of the peculiarities in analyzing the positive and negative effects of vertical mergers and the application of effective remedies, the panel "New perspectives for vertical merger analysis: challenges in application of remedies and use of quantitative methods" aims to promote a discussion on the main issues that arise in the analysis of vertical mergers. This panel will discuss the contributions of quantitative tests to antitrust analysis (such as the vertical arithmetic and vGUPPI) as well as the challenges of applying behavioral remedies. To meet the proposed objective, the panel will include lawyers, economists, and policymakers in a Q&A format.

2. Operation effects analysis

According to CADE's resolution No. 09 October 2014⁸, vertical mergers in which any of the applicants have a market share higher than 30% of any of the markets analyzed (not considering the production of inputs for captive consumption by the parties) are subject to classification in the ordinary rite by the Court, demanding a more detailed analysis.

a. Market power and possibility of market foreclosure

Vertical integration carries the risk of foreclosure, either in the upstream or the downstream market. In the first case, an integrated firm with market power in the downstream market may not buy from rivals in the upstream market. In the

⁷ ICN Vertical Mergers Survey Report.

⁸ Resolution No. 01 October 2014, pp.3. Available in:< <http://www.cade.gov.br/assuntos/normas-e-legislacao/resolucao/resolucao-9-01outubro2014-alteracao-res-022012.pdf/view>> Last access on 08/16/2019.

second case, the merged company may restrict rivals in the downstream market from access to essential inputs fabricated upstream.

Therefore, it's necessary to understand if the merged company would gain enough market power to be able to adopt practices that lead to market foreclosure. Factors such as the essentiality of an input and the ability of rivals to access it are decisive in this analysis. In addition, it's important to analyze competitive conditions such as entry barriers and remaining rivalry, in order to identify remaining rivals ability to (i) sell its products (if the competitive concern involves the upstream link) or (ii) access inputs (if there's a possibility of downstream foreclosure).

b. Efficiencies

As in the case of horizontal mergers, the analysis of vertical integrations investigates the possible pro-competitive effects derived by the operation. Efficiencies tend to be more evident in vertical than in horizontal mergers, in line with what was proposed by the Chicago school. The main efficiencies tend to be derived mainly from scope economies (Scherer and Ross, 1990); reduction of information asymmetries (Lafontaine and Slade, 2010); reduction in transactions costs (Williamson, 2005); as well as the increase in quality of products and eliminating double-marginalization (Posner, 1976 and Bork, 1978)⁹.

This last element is particularly relevant, as it's generally understood as the main efficiency derived from vertical integration. This efficiency is related to the suppression of a transaction between two links that have power in their respective market, so the economic margin of the first link is eliminated. If this efficiency is passed on to the consumer, there's an increase in welfare.

There are also gains related to reducing transaction costs and information asymmetry, especially in markets characterized by the presence of *moral hazard*.

⁹ Azevedo, Paulo (2010) – Restrições Verticais e Defesa da Concorrência: a experiência brasileira- < <http://bibliotecadigital.fgv.br/dspace/bitstream/handle/10438/6895/TD+264+-+Paulo+Furquim+de+Azevedo.pdf?sequence=1> > Last access on 16/08/2019.

A classic example is the healthcare industry, where verticalization brings gains by eliminating agency problems.

The conclusion about the net effect of an operation depends of the efficiencies and the assessment of possible competitive harms, as to determine how the merger should impact consumer welfare. The panel seeks to discuss what would be limitations on obtaining accurate information, ways to measure potential harms and efficiencies and the most appropriate remedies to dismiss competitive concerns whilst preserving efficiencies, when necessary.

3. Quantitative tests in the assessment of possible deleterious effects of the operation

When the antitrust concern is related to input price discrimination, certain quantitative tests are available that may support the discussion. One of these tests is the vertical arithmetic, which consists in evaluating the possible gains to the merged firm that could be passed on to the market at risk of foreclosure, compared to the possible losses incurred by the company in the market used to conduct the foreclosure.

Another quantitative tool is an index that, considering the efficiencies of the operation, describes the merged company's incentive to increase price: vGUPPI. Developed by Moresi and Salop¹⁰, the vGUPPI is an adaptation of the GUPPI test (which originally seeks to indicate the incentive of a horizontal operation to result in a price increase) for vertical operations. More precisely, the index measures the merged company incentives to increase prices in the upstream market (vGUPPIu); the incentives to transfer input prices by competitors in the downstream link (vGUPPIr); and the merged firm's incentives to increase prices in downstream link (vGUPPId).¹¹

¹⁰ Moresi, S. and Salop, S.C. (2012) 'vGUPPI: Scoring Unilateral Pricing Incentives in Vertical Mergers', *Antitrust Law Journal*, 79:1, p. 187–214. Available in <https://scholarship.law.georgetown.edu/cgi/viewcontent.cgi?referer=https://www.google.com/&httpsredir=1&article=1167&context=fwps_papers> Last access on 08/19/2019

¹¹ Moresi, S. and Salop. Updating the Merger Guidelines: Comments. 2009. Available in: <https://www.ftc.gov/sites/default/files/documents/public_comments/horizontal-merger-guidelines-review-project-545095-00032/545095-00032.pdf> Last access on 08/19/2019

Currently, these tests are not systematically applied in the analyses of antitrust authorities. In Brazil, the use of vGUPPI is not yet institutionalized in CADE's vertical merger analysis, and it's more common to use vertical arithmetic analysis. Similarly, in other jurisdictions, most antitrust authorities adopt the vertical arithmetic method, and the use of vGUPPI¹² is less frequent.

Even though in the recent period there is a greater receptivity to the application of quantitative tests such as vGUPPI, it is also noticed that its application is made with thrift, understanding the limitations inherent to these exercises - there are, in fact, questions with nontrivial answers: (i) On vGUPPI, what should be the appropriate threshold for ruling out competitive concerns¹³? (ii) how to deal with any incompleteness with the market information?; (iii) what is the appropriate way to reconcile quantitative and qualitative conclusions when they are divergent?

4. Remedies

According to CADE's Remedies Guidelines, the elaboration of restrictions for approval an operation must follow the principles of proportionality, timeliness, feasibility and verifiability. One of the peculiarities of vertical integrations is the almost always direct association of the efficiencies generated with the structural aspects of the operation. Thus, it is understood that structural remedies can compromise the efficiencies generated by the operation, directly affecting the proportionality and viability of the remedy, and, therefore, tend not to be recommended for operations of this type. The application of behavioral remedies tends to be more common, even though their use is thrift, since it implies higher monitoring costs for the authority and because it may increase the risk of distortions in the market.

¹² ICN MWG Vertical Mergers Survey. ICN Annual Conference 2018. Available in: < <http://icn2018delhi.in/images/ICN-survey-report-on-vertical-mergers-17-03-18.pdf> > Last access on 20/08/2019

¹³ In the decision of the case Tesco/Booker given by CMA (Competition & Markets Authority), the English antitrust authority considered as a parameter that 10% would be a threshold that would indicate possible competition problems, a more conservative index than previous decisions in horizontal mergers that used the GUPPI quantitative test in the same court.

All this reinforces that it's important to discuss if vertical merger remedies are, in fact, effective - not only to remove competitive concerns, but also to preserve the efficiencies of the operation without creating high costs for the merger or generating markets distortions.

5. Panel format and participants

The panel will be divided into Q&A blocks: the moderator will ask questions for panelists to answer, and their answers may be commented by the moderator and/or other panelists.

To contribute to the debate, the panel will include lawyers and economists that work in Brazil and other jurisdictions (Europe and USA), as well as a CADE representative. All participants have relevant experience in the subject, either through participation in cases involving complex analysis and negotiation of medicines, or through research and academic publications.

Conclusions

The analysis of vertical operations has become more constant and there are still relevant issues to be debated, like the best analysis criteria, quantitative tools and the application of remedies. The panel must promote discussion of these topics by exploring the various issues, including those raised throughout this article on different topics:

- Harm analysis:
 - How to analyze the results of quantitative tests with vGUPPI: as a filter or evidence of competitive concern?
 - How to deal with any incompleteness in market information?
 - What is the appropriate way to reconcile quantitative and qualitative conclusions when they diverge?
- Efficiencies
 - How to overcome limitations on obtaining accurate information and non-speculative analysis?
 - How to measure the possible gains versus the potential for competitive harm?

- Remedies
 - Were the remedies. usually behavioral, effective?
 - Do structural remedies compromise the efficiencies that result from the operation?