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DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS
COMPETITION COMMITTEE

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ROUNDTABLE ON VERTICAL MERGERS

-- Note by Germany --

This note is submitted by the German Delegation to the Competition Committee FOR DISCUSSION at its forthcoming meeting to be held on 21-22 February 2007.

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1. The term "vertical merger"

1. German competition law does not contain a legal definition of the term "vertical merger". The Bundeskartellamt assumes the existence of a vertical merger where the participating companies are not active in the same market (which would be the case in a horizontal merger) but are operating in up-stream and down-stream levels of the production or sales process. Conglomerate mergers on the other hand are mergers where the products of the participating companies stand in a complementary or substitutional relationship to one another.

2. In the Bundeskartellamt's practice, however, there are only relatively few mergers that are "purely" horizontal, vertical or conglomerate. The majority of the mergers notified to the Bundeskartellamt affect several markets. As a consequence, one and the same merger can have horizontal, vertical and conglomerate features. The definition of the relevant market also plays a significant role that should not be underestimated because it depends on the market definition as to under which category a merger falls.

2. Statutory basis for the examination of vertical mergers

3. The German Act against Restraints of Competition (ARC) stipulates that a merger is to be prohibited if it is expected to create or strengthen a dominant position (Section 36 (1) ARC). The Act does not distinguish between horizontal, vertical or conglomerate mergers.

4. Under the ARC a company is dominant if, as a supplier or buyer, it has a paramount market position in relation to its competitors. In assessing whether a paramount market position exists account is taken in particular of the company's market share, its financial power, its access to supply or sales markets, its links with other companies, barriers to entry, potential competition, and its ability to shift its supply or demand to other goods or commercial services (Section 19 (2) No 2 ARC).

3. Anti-competitive effects of vertical mergers

5. Since vertical mergers do not lead to an addition of market shares, the Bundeskartellamt's examination focuses in particular on the question of whether or not the merger will lead to market foreclosure effects. Such market foreclosure effects occur in particular where, on account of its own excellent access to the supply or sales markets, a dominant company can make access to these markets difficult or even impossible for its competitors.

6. Vertical integration and the possibilities it offers to force out competitors or foreclose the market is an issue that is frequently discussed in economic literature. Market foreclosure effects can occur both at the upstream and the downstream market level. Where, for example, access to preliminary products is impeded, competition can be hindered by the integrated company through its pricing policy vis-à-vis the buyers of these products or through its pricing strategy on the sales market.

7. Where a company has better access to supply and sales markets than its competitors this can lead to a deterioration of market structures. In the Bundeskartellamt's view this requires, however, that at least one of the participating companies has had a strong market position even before the merger. The merger thus may only have anti-competitive effects if the vertically integrated company gains a dominant position post-merger on one of the markets affected. In addition it has to be examined whether competitors depend on the supply by or demand from the vertically integrated company. For example, one important aspect for the competitive assessment is whether or not access to scarce commodities or resources will be impeded by the merger.

8. Anti-competitive effects can also occur if a potential competitor is deterred by the vertical merger. Here, the assessment has to focus in particular on whether or not the competitor would have entered the dominated market had the merger not occurred.

9. Another aspect to be examined is the transfer of financial power, which opens up possibilities to squeeze out competitors, e.g. by lowering sales prices.

10. The three cases reported below illustrate these assessment principles. The first two cases exemplify under which conditions anti-competitive effects are established (case 1) or not established (case 2). The third case illustrates the Bundeskartellamt's enforcement practice in the energy supply sector. Electricity and gas markets are the most important sectors of the Bundeskartellamt's enforcement practice with regard to vertical mergers. In these markets there is already a high degree of vertical integration with negative effects on competition. The Bundeskartellamt has issued several prohibition decisions and clearances subject to remedies against vertical energy mergers during the past years.

3.1 Case example: Axel Springer Verlag AG / PSG Postdienst Service GmbH

11. In 1997 the Bundeskartellamt prohibited the acquisition of PSG Postdienst Service GmbH (PSG) by Axel Springer Verlag AG (Springer).

12. At that time PSG was owned by Deutsche Post AG and operated about 240 press retail outlets, of which 31 were railway station bookshops, in the Eastern *Länder* of Germany. Springer, the acquiring company, was a media company mainly engaged in the area of newspapers, magazines and printing products. Amongst other products, it published the "Bild-Zeitung", the tabloid with the widest circulation in Germany.

13. According to the Bundeskartellamt's findings the acquisition of PSG would have strengthened Springer's dominant position in several markets, including the national and the Berlin reader market for over-the-counter newspapers and the respective markets for newspaper advertising.

14. Springer's dominant position would have been strengthened due to its participation in a downstream sales level, in this case the press retail sector. This would have been the first time that a publishing house participated in a downstream sales level. Until that time press distribution in Germany had been structured in a way which guaranteed neutrality vis-à-vis the publishing houses, i.e. distribution conditions were the same for each newspaper or magazine. The acquisition of PSG would have led to a vertical integration, which would have offered Springer the opportunity to exert influence on the activities in the final distribution level and thus improve its access to the sales markets. At the same time access conditions for actual competitors would have deteriorated and barriers to market entry for potential competitors increased. Moreover, Springer would have gained the possibility to expand its market position to newspaper markets that until then had not been dominated und consequently to indirectly secure its position in those markets which it already dominated.

3.2 Case example: Nokia Corp. / Symbian Ltd.[1]

15. In 2004 the Bundeskartellamt examined a project by Nokia, the world's leading manufacturer of mobile phones, to increase its share in Symbian Ltd. by 31.1 % to a total of 63.3 % after the merger.

[1] The full text of the decision is available at http://www.bundeskartellamt.de/wDeutsch/download/pdf/Fusion/Fusion04/B7-29-04.pdf

16. Symbian was founded in 1998 as a joint venture of Ericsson, Nokia and Psion. The company's objective was to develop an open operating system standard to match the requirements set by hardware manufacturers of mobile devices. Symbian developed the "Symbian OS" operating system and licensed it worldwide to its shareholders and other manufacturers of mobile devices. Symbian had a subsidiary, UIQ Technology AB, which developed and licensed a user interface (interface between user and hardware) that could only be used together with Symbian OS.

17. The Bundeskartellamt's investigations showed that the merger not only had vertical effects on the worldwide market for smartphones but also horizontal effects on the worldwide market for integrated operating systems for these devices. In the vertically affected market the investigation focused on the question of whether the merger could be expected to foreclose this market or permanently secure Nokia's market position.

18. At the time of the decision Nokia was the world's leading supplier of smartphones with market shares between 50 % and 95 % in Europe. However, this market position was not yet secured as the market for smartphones was still in an expansion phase.

19. Even before the merger took place a shareholder agreement safeguarded non-discriminatory access to the Symbian products for all shareholders. Although the merger provided Nokia with extensive opportunities for influence, these did not significantly increase Nokia's access to the primary products Symbian OS and Symbian/UIQ. In fact the merger did not alter the fact that shareholders would have non-discriminatory access to Symbian's products. Moreover, Nokia's influence on Symbian/UIQ has been restricted due to an additional agreement with Sony-Ericsson which was concluded during the course of the merger control proceedings. In this additional agreement Nokia committed itself not to hinder fair and non-discriminatory access for its competitors to Symbian OS or Symbian/UIQ. Furthermore Nokia agreed to support the further development already planned for Symbian/UIQ.

20. Finally, a foreclosure of the market for smartphones was not to be expected because most of Nokia's competitors were not dependent on supplies by Symbian. In view of the "Microsoft Smartphone" integrated operating system, Palm OS and Linux in connection with Java, the competitors had sufficient possibilities to switch to alternative suppliers.

21. The proposed concentration was therefore cleared.

3.3 Case example: Mainova AG / Aschaffenburger Versorgungs GmbH[2]

22. In 2004 the Bundeskartellamt prohibited the proposed acquisition of shares in Aschaffenburger Versorgungs GmbH ("AVG") by Mainova AG ("Mainova"). In the Bundeskartellamt's view the project was likely to strengthen the dominant positions of Mainova and AVG in the gas supply market.

23. Mainova, a company predominantly owned by the City of Frankfurt, is a regional energy provider (electricity, gas, heating and water) operating in and around the city of Frankfurt/Main.

24. AVG, a company owned by the City of Aschaffenburg supplies end customers in the city of Aschaffenburg with electricity, gas, water and district heating. AVG's gas supply network is connected to Mainova's grid gas network.

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2 The full text of the decision is available at http://www.bundeskartellamt.de/wDeutsch/download/pdf/Fusion/Fusion04/B8-27-04.pdf

25. The following relevant markets were defined in this case: Firstly, the distribution level of the regional grid gas supply which, in geographic terms, covered Mainova's transmission network suitable for supplying local distributors; and secondly, the end customer market for gas (i.e. large and small customers) which, in geographic terms, was represented by AVG's gas distribution network.

26. The Bundeskartellamt's investigations showed that the merger would have enabled Mainova to strengthen its dominant position in the supply to municipal utilities in its network area. This would have been achieved by securing the already existing supply to AVG. Mainova's rights to information and possibilities to exert influence via its representation on the supervisory board would have increased its chances to be considered for new gas supply contracts. Furthermore Mainova would have gained extensive knowledge of its competitors' offers and might have been able to undercut them.

27. It was also to be expected that AVG and its municipal majority shareholder would consider the interests of the minority shareholder, i.e. Mainova. In the case of two equivalent offers, the final decision was likely to be in favour of the offer submitted by the minority shareholder. The planned shareholder structure also had a certain deterrent effect on other suppliers so that these would be prevented from the start to make a competing offer for the supply of gas to AVG. Potential competitors would be discouraged as well from engaging in aggressive competitive behaviour. The participation would therefore increase Mainova's ability to ward off follow-up competition.

28. The merger would also have strengthened AVG's dominant position in its network area. Potential competition from Mainova would thus be stifled from the start. Without the association under company law Mainova would have had an incentive to offer gas supply to small customers by transmission. This would have involved aggressive competition which could have been initiated above all by Mainova which, as the closest upstream network operator, was in a better position to do this than any other regional gas supply company. The proposed association would definitely have been unlikely to result in the development of such a transmission competition between Mainova and AVG.

4. Efficiencies

29. As the "scoping paper"[3] explains, vertical mergers can give rise to several types of efficiencies. These include, in particular, enhanced coordination, alignment of incentives, production efficiencies, transaction cost savings, internalization of non-price externalities and as well as the internalization of price externalities, in particular the elimination of double marginalization. The Bundeskartellamt does not share the view that vertical mergers normally lead to significant efficiencies as empirical studies do not seem to support such a general statement. Vertical mergers may or may not lead to merger-specific efficiencies.

30. In its case analysis, the Bundeskartellamt generally treats efficiencies neither as an efficiency offence nor as a formal efficiency defence. Under German merger control efficiency gains and competitive disadvantages are generally not quantified on a case-by-case basis. Although the ARC does not provide for an explicit efficiency defence, in its substantive evaluation the Bundeskartellamt has to weigh up the positive and negative competition effects of the merger on the relevant markets. The creation or strengthening of a dominant position can only be predicted if the expected negative effects of the merger on the structure of the market outweigh the possible positive effects.

31. The German law also stipulates that a merger cannot be prohibited if the companies involved prove that the merger will also lead to improvements of the conditions of competition which outweigh the disadvantages of dominance. (Section 36 (1) of the ARC) The parties to the merger can invoke this clause if the substantive examination of a merger concludes that the requirements for prohibition are fulfilled.

3 COMP/2006.102

However, to avert a prohibition it would have to be proved that the merger would improve competitive conditions on a market other than the one affected by the merger, on which market dominance is created or strengthened. High demands have to be placed on the quality of improvement on the alternative market to be considered for this to outweigh the deterioration of competition structures on the dominated market. As a general rule the alternative market also has to be dominated and this dominance reduced by the merger. This rule generally allows for the consideration of pro-competitive effects of mergers in third markets.

4.1 Case example: SES Astra/Premiere Digital Playout Center[4]

32. Even if German merger control does not provide for an explicit efficiency defence, the Bundeskartellamt weighs the positive and negative competition effects of the merger on the relevant markets affected. An example where the pro-competitive effects outweighed the anti-competitive effects was the clearance in December 2004 of the acquisition by SES Global Europe S.A. of all the shares in DPC Digital Playout Center GmbH of the Premiere Fernsehen GmbH & Co. KG.

33. The takeover affected the market for broadcasting satellite programmes as well as the pay TV end consumer market in Germany. SES Global operated the ASTRA satellite fleet in Europe and in particular provided transponder capacity to broadcasting service providers for the transmission of programmes via satellite to end consumers (DTH "direct to home"). DPC provided Premiere with intracompany technical services for pay TV (so-called digital platform: encoding, SmartCard management, set-top boxes).

34. The merger led to a strengthening of SES Astra's dominant position in the national market for DTH transponders. The strengthening of SES Astra's dominant position resulted from the vertical integration of the dominant satellite provider with the only service provider which was able to grant access to the Premiere set top boxes for satellite reception. Thus, two essential technical components of pay TV advance services were bundled under one provider.

35. However, the unbundling of the digital platform for pay TV from Premiere resulted in improved conditions of competition in the national pay TV market. So far, Premiere had dominated the pay TV market and sealed it off by using proprietary encoding technology and a matching set top box infrastructure. With the merger, access to the established set top box infrastructure was provided by SES Astra, a company which is independent of Premiere. Thus, a significant entry barrier to the pay TV market was eliminated. According to the Bundeskartellamt's findings, the positive effects on the pay TV market outweighed the negative effects on the DTH transponder markets.

5. Enforcement policy and remedies

36. The Bundeskartellamt also scrupulously examines vertical mergers because under certain circumstances they can also have damaging effects. A "presumption of unobjectionability" sometimes called for in the case of vertical mergers seems inappropriate.

37. Also in the case of vertical mergers the prohibition of abusive practices cannot replace merger control. Only a proportion of the possible negative effects of vertical mergers are covered under the prohibition of abusive practices. The hypothesis that private and state sanctions for violating the prohibition of abusive practices are generally sufficiently deterrent to prevent illegal predatory or market foreclosure practices, is questionable since the actual deterrent effect of sanctions cannot be estimated reliably.

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4 The full text of the decision is available at http://www.bundeskartellamt.de/wDeutsch/download/pdf/Fusion/Fusion05/B7-150-04.pdf

38. Contrary to the opinion of the European Court of First Instance in the cases Tetra Laval/Sidel and GE/Honeywell it is not generally useful to establish the deterrent effect of the prohibition of abusive practices in a specific case. In many cases even the assessment of whether a hypothetical behaviour would violate the prohibition of abusive practices is ambiguous. If a competition authority were to carry out an ex-ante substantive assessment of each possible variant of abuse of power, it would soon run up against its limits. Irrespective of these practical problems, such an "Article 82 defence" leads to a paradoxical result: As the most damaging hypothetical practices would be most likely to violate the ban on abusive practices, only the more harmless variant/practices can be assumed for analysis under merger control.

39. If a competition authority's prohibition decision in the case of a vertical merger is based on future behaviour, the appropriate standard of proof is whether, from an economic point of view, this behaviour is likely to occur. In German practice and case law structural criteria are given primary consideration, also in the examination of vertical mergers. The Bundeskartellamt's prohibition decisions are thus not primarily based on the participating parties' likely future behaviour, but above all on the merger's possible effects resulting from market foreclosure, the elimination of potential competition and increased financial strength. If a prohibition is based on the participating parties' future behaviour, the standard of proof applied by the Bundeskartellamt is whether this behaviour is likely to occur. A certain behaviour is to be considered likely if it is possible and commercially reasonable.

40. Under German merger control only structural remedies are admissible, in particular, for instance, the obligation to sell companies or parts of companies. Any remedy which would subject the conduct of the companies concerned to continued control, is explicitly inadmissible under German competition law (§ 40 (3) sentence 2 ARC). Accordingly the Bundeskartellamt would not be able to clear a merger subject to a remedy that forbids the companies to resort to abusive practices. This regulation corresponds with the experience gained by the Bundeskartellamt that behavioural remedies are generally not a suitable method to dispel competition concerns under merger control.