

# CRA Competition Memo



## A New Doctrine in Merger Control?

The European Commission's recent adoption of a new theory of "portfolio power" is a significant development: from now on, conglomerate mergers that do not increase market shares in any relevant market may be subject to considerably greater scrutiny. This new approach has formed part of the decision in at least three cases: Coca Cola and Amalgamated Beverages; Coca Cola and Carlsberg; and, most recently, Guinness and Grand Metropolitan.<sup>1</sup>

### The Guinness/GrandMet Merger

The clearest illustration of the new doctrine is provided by the merger of Guinness and GrandMet. The merger created GMG Brands (now called Diageo), bringing together two portfolios of brands which appeared complementary. In Europe, Guinness was strong in gin but lacked a leading vodka; GrandMet was strong in vodka but lacked a leading gin. Both parties were strong in whisky but in most countries where one was strong the other was relatively weak.

But the very feature that appealed to the businessmen – complementarity between product lines – set the alarm bells ringing within the Commission. The Commission was concerned that the merger would result in a company with a portfolio of brands across different relevant markets (spirits categories such as whisky, gin, vodka, etc.) that would lead to portfolio power. It argued that this in itself could create or strengthen a dominant position regardless of the lack of increase in market share in the individual spirits categories. The Commission insisted that the merged firm relinquish the distribution of Bacardi in Greece, despite the fact that the merger produced no increase in market shares for rum.

### What is Portfolio Power?

So far the Commission has raised portfolio power issues only in those multi-market mergers where the products being merged have a common customer who buys a range of products (usually a retailer). The underlying rationale behind portfolio power was summarised by a competitor as follows: *"the market power deriving from a portfolio of brands exceeds the sum of its parts"*. But what is the source of this additional market power?

Possibilities identified by the Commission include the following.

1. The merged firm would be more attractive because it would offer a range of products.
2. Economies of scale and scope would be realised in sales and marketing.
3. There would be greater potential for tying products.
4. The threat of a refusal to supply would be more potent.

Are these arguments persuasive? As always in competition law, the relevant question should be how customers would be affected. The first two possibilities should not harm the customers of the merged firms because they lower costs. Competitors might be worse off, but this is not in itself a valid basis for regulatory intervention. The latter two possibilities – tying and the refusal to supply – are of particular concern when there is a chance that rivals will be excluded from the market. However, there was no suggestion in the GMG case that the merged firm's main pan-European rivals would leave the market.

### Possible Sources of "Portfolio Power"

In the three cases so far, the Commission has pointed to three characteristics of the merged firm provided the mechanisms which could have allowed portfolio power to be exercised.

#### • **Wide Portfolios and "Must Stock" Brands**

First, the Commission has focused on the increased range of important, or "must stock", brands under the control of a single company. The combination of a number of these brands was thought by the Commission to increase the bargaining power of the brand owner. However, it was never made clear by the Commission what exactly was claimed to be the source of the "extra" market power conferred by a combination of category-leading brands.

#### • **The Effect of Size**

Second, the Commission has argued that the growth in overall size of the merged firm would give it increased market power, simply through its greater importance as a trading partner for its customers. Does this mean that a merger between related products in distinct relevant markets can confer market power, without there being any change of market share within the relevant

<sup>1</sup> Lexecon acted as economic advisers in two of these cases.

markets? If so, it would represent a radical departure from standard merger analysis.

• **Deep Portfolios and Secondary Brands**

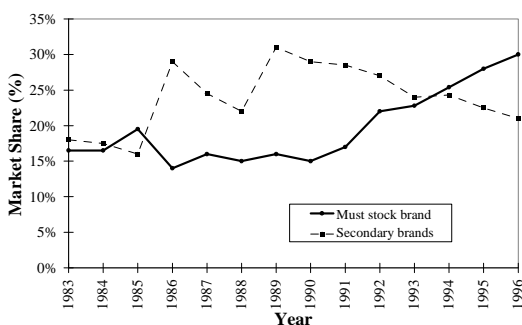
The final argument has related to “depth” rather than width of portfolios. The Commission has argued that control over a large number of brands would allow the supplier to “pull-through” secondary brands as a result of control over a strong brand. But in each case it was never made clear how joint control over a high-selling brand and a secondary brand can allow the supplier to “force” the latter on reluctant customers.

**Testing for Portfolio Power**

The validity of these theories can be debated, but ultimately what matters is whether they are borne out by the facts. A number of the propositions which together form the theory of portfolio power can be tested empirically. For example, is it the case that the ownership of must-stock brands facilitates the leverage of secondary brands? We were able to examine this in the GMG Brands case.<sup>2</sup>

As a brand develops into a position as market leader, the portfolio effect hypothesis predicts that the market share of those secondary brands also owned by the brand leader will expand. This expansion reflects the newly won leverage of the must stock brand. The emergence of a new market leader, then, ought to be followed by an improvement in the position of second string brands. The chart (below) shows how the market shares of a must stock brand and its associated secondary brands actually varied in one of the “problem” markets identified by the Commission.<sup>3</sup>

**Relationship between Brand Market Shares**



The chart shows that there was no evidence at all that a must stock brand allowed secondary brands to be levered. Indeed, the secondary brands

declined during the period in which the current market leader improved.

Of course, this tests only one aspect of the portfolio power theory. There can be no single definitive empirical test for portfolio power as the theory itself is comprised of a number of separate propositions. Yet the need to reconcile the theory with the evidence is of paramount importance if portfolio power is to be used by the Commission to win concessions in merger cases.

**Implications for Conglomerate Mergers**

If the portfolio power theory is applied more widely, serious problems could emerge for firms seeking to use mergers to diversify their interests, particularly within branded consumer products. Consider the hypothetical merger of two firms, one of which owns a range of cereal brands and the other which owns a range of coffee brands. There is no sense in which the two products compete and no possibility of an increase in any market share. However, if the merger creates a large company with must stock brands in both coffee and cereal, the literal application of the portfolio power approach could lead to the merger being blocked or – more likely – it could be used to extract some juicy brand divestments for the benefit of complainant competitors.

**Conclusions**

It seems highly likely that the portfolio power approach will be applied in future merger cases. At an intuitive level, the idea that there might be cause for concern if a company owns a wide range of key brands which are sold to a customer has some resonance. However, caution is in order. While the conventional theory of horizontal mergers is by no means uncontroversial, there is at least some degree of consensus on workable criteria. By contrast, no such understanding exists in relation to portfolio-based arguments. It is noteworthy that in the GMG case the US authorities rejected the portfolio power theory.

In its current form, the portfolio power approach is made up of a number of disparate ideas which are not supported by a unifying economic theory. It may be that one day the Commission will formulate a sound theory with clear decision criteria. Until this happens, we share the scepticism of the US authorities. It is to be hoped that the Commission will tread cautiously until a practicable and empirically supported set of rules is established – if it ever is.

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<sup>2</sup> Another problem is that the concept of a must stock brand is hard to define meaningfully. In the example used, “market leader” and “must stock” are used interchangeably. It is not clear, however, that any brand is truly must stock.

<sup>3</sup> The identity of the market and all details have been omitted for reasons of confidentiality.