

EC Non-Horizontal Merger Guidelines in practice:

TomTom / TeleAtlas



INTERNATIONAL

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Outline of presentation

- **Basic economics of vertical mergers**
- **The framework of the Non-Horizontal Merger Guidelines**
- **Tom Tom / TeleAtlas**
- **Mergers of hospitals and medical insurers**

Basic economics of vertical mergers

- **Generally not expect vertical mergers to cause competition policy problems**
 - Products in a vertical merger are complements, not substitutes
 - Mergers of complements generally expected to lead to price reductions
 - Firms want the price of complements to be low
- **Horizontal mergers conceptually simpler as only a limited number of theories of harm in horizontal mergers**
 - Substitutes merge, so competitive constraint relaxed, so prices rise
 - Fewer firms post-merger, so coordination easier, so competition becomes softer and prices rise

Basic economics of vertical mergers (*cont.*)

- **Theories of harm in vertical mergers are less clear and less direct:**
 - Direct price effect actually pro-competitive
 - If harm arises it is because a change in the behaviour of merged entity leads to harm to a competitor, which leads to harm to competition
 - Plausible stories will be based on foreclosure
 - But must avoid equating harm to competitors with harm to competition
 - Many possible stories for how harm may occur
- **Efficiency claims in vertical mergers more likely to be valid than in horizontal mergers**
 - Pricing efficiencies likely, particularly if there is market power at both levels
 - Double marginalisation
 - EC accept this in its Non-Horizontal Merger Guidelines

EC Non-Horizontal Merger Guidelines

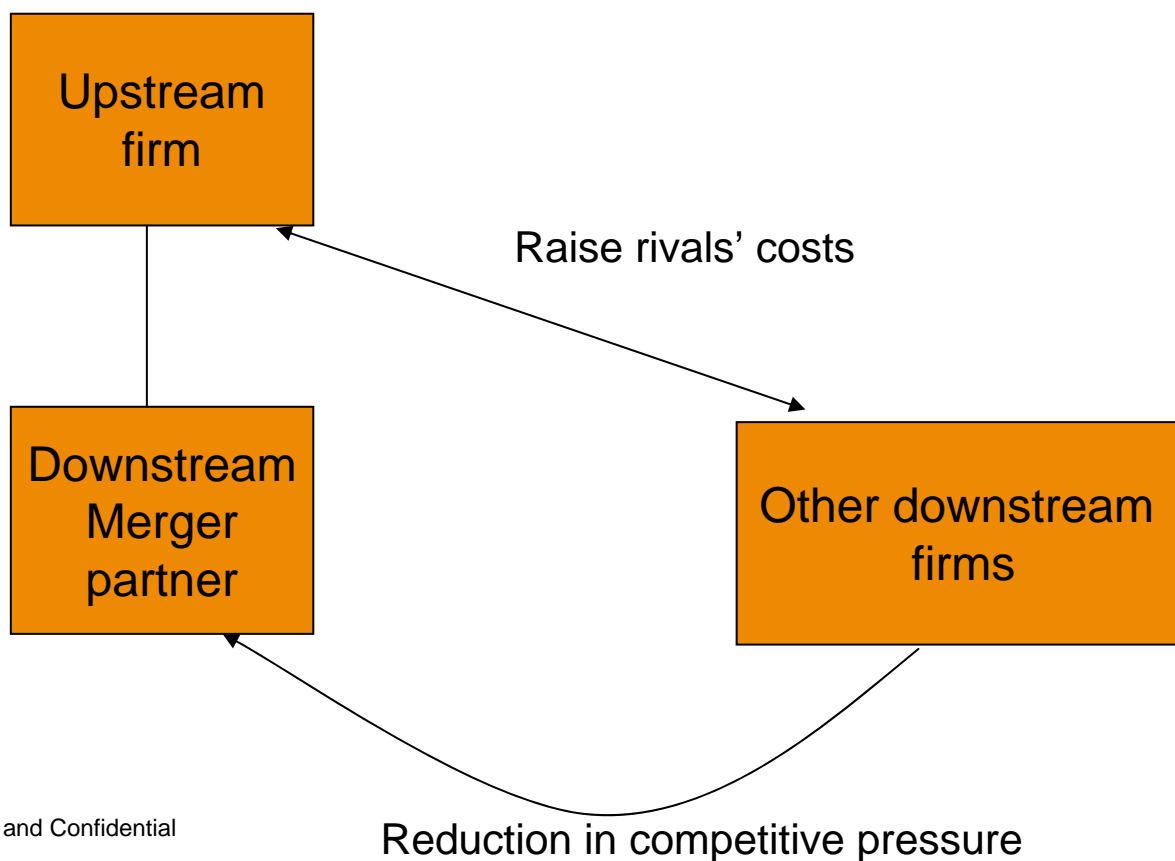
- **Commission raises two theories of unilateral effect harm in vertical mergers:**
 - Input foreclosure:
 - upstream firm restricts access to its input to the downstream firm's rivals
 - this raises downstream rivals' costs and so relaxes competition at the downstream level, thus leading to higher prices downstream and harm to consumers
 - Customer foreclosure:
 - downstream firm restricts its purchases from upstream firm's rivals
 - leads to a loss of economies of scale for upstream rivals
 - leads to higher prices to downstream rivals
 - leads downstream rivals to raise their prices, to the benefit of the merged firm's downstream arm and to the detriment of consumers
- **Commission also raises coordinated effects concerns**
 - These relate to reductions in number of players, the acquisition of a maverick, increased symmetry and increased transparency

Framework of the guidelines

- **Need to show:**
 - Market power at one level (at least)
 - Ability to foreclose
 - Incentive to foreclose
 - Impact on competition leading to consumer harm
- **All four are necessary conditions**
- **Particular care required when going from ability to foreclose to incentive to foreclose**

Example of where care is needed

- Will the merger of the upstream dominant firm and a downstream firm be anti-competitive?
- Theory of harm:
 - Upstream firm merges with downstream firm, raises costs of inputs to rivals, who therefore raise their prices, so merged entity can raise its price



Example of where care is needed (*cont.*)

Is this a coherent theory of harm?

- If the upstream firm provides an essential input, it may have significant market power and hence the ability to raise input costs above the competitive level
 - But why does it need a merger to achieve this end? Why could it not raise prices to all downstream firms without the merger?
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- **Ability to foreclose clear, but incentive much less clear**

TomTom/Tele Atlas (2008)

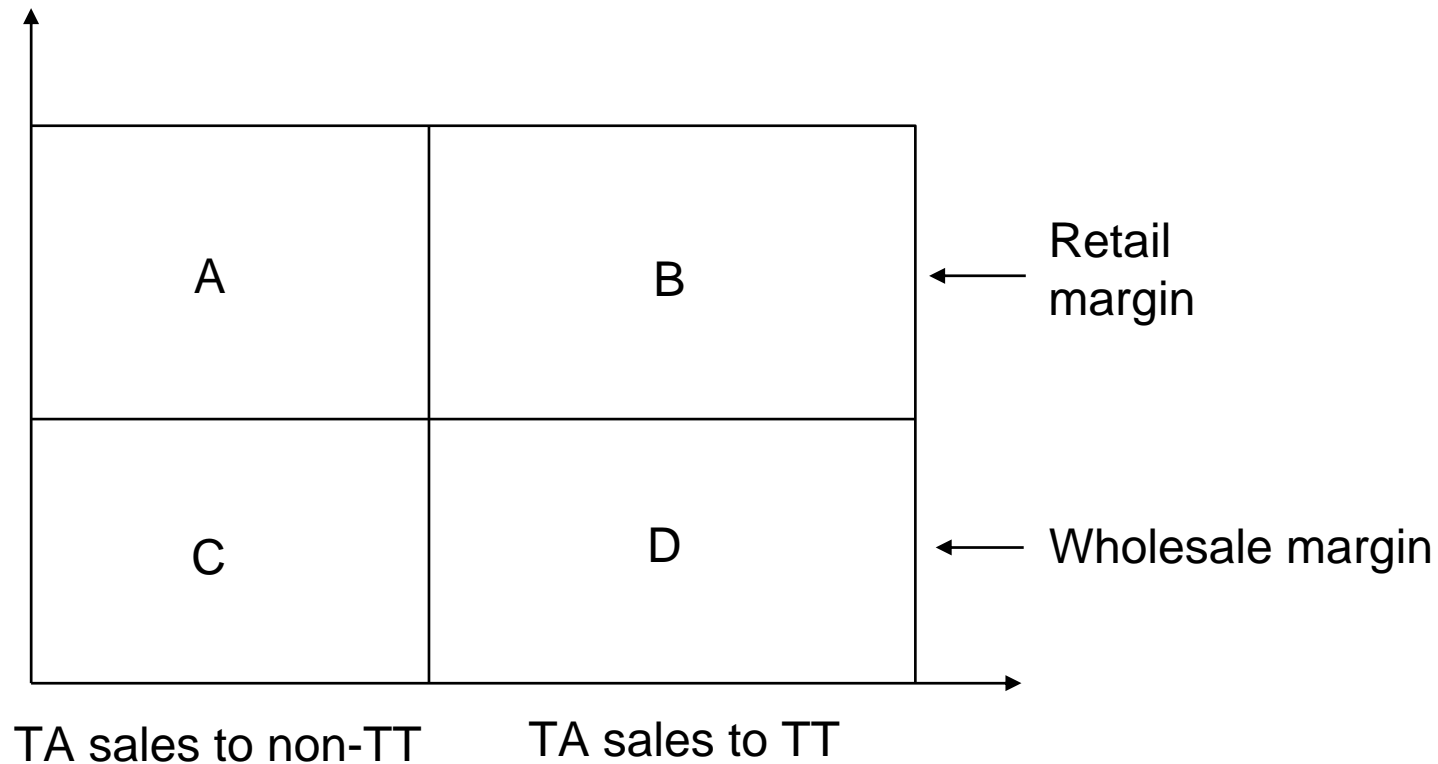
- **First merger looked at in depth under the new Non-Horizontal Merger Guidelines**
- **TomTom was the leading producer of portable navigation devices (SatNavs) in Europe**
- **Tele Atlas largest of only two providers of navigable maps in Europe**
 - Navteq the other provider
- **Possible theories of harm**
 - Customer foreclosure: not applicable as TT already bought virtually all its maps from TA
 - Input foreclosure:
 - Post-merger TA would no longer supply TT's competitors (or only on worse terms)
 - This would lead to higher input costs for TT's rivals as Navteq would become a monopoly supplier of maps to TT's rivals
 - This would lead to higher retail prices from TT's rivals
 - This would reduce the competitive constraint on TT, thus leading to more sales and higher prices for TT

TomTom/Tele Atlas (*cont.*)

- **EC decided both Tom Tom and Tele Atlas had market power**
 - Tom Tom market share about 40%
 - Tele Atlas market share about 60%
- **EC decided TT/TA had the ability to foreclose rivals from access to TA maps**
- **But would TT/TA have an incentive to foreclose?**
 - Downstream margins higher than upstream margins
 - Thus extra sales downstream more valuable than lost sales upstream
 - This suggests a foreclosure strategy leading to lost margins upstream but higher sales downstream may be profitable
 - Empirical analysis required to determine which effect dominates

TT/TA vertical arithmetic

- Pre-merger TA earns area C + D
- TT earns area B

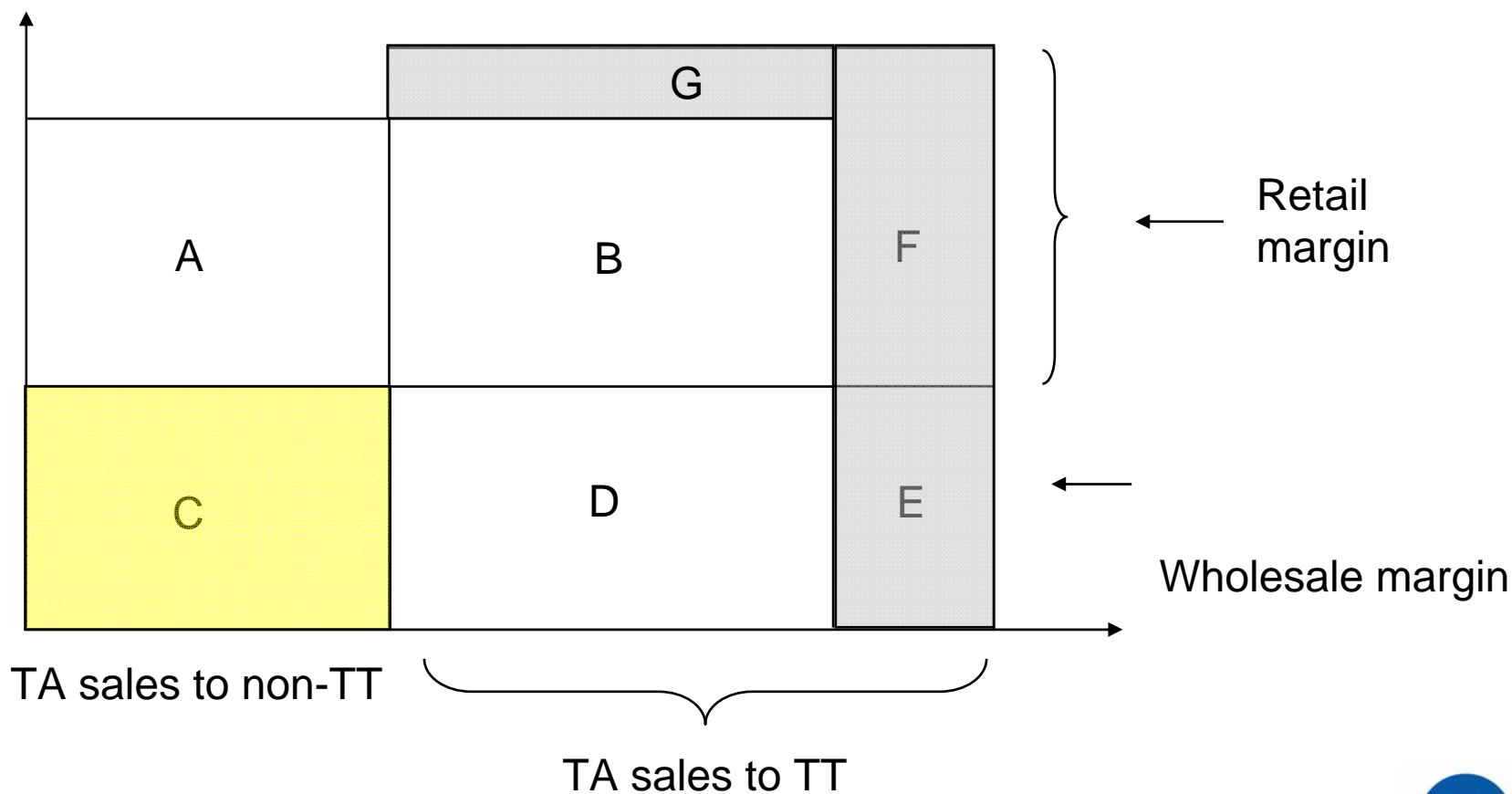


TT/TA vertical arithmetic

- EC theory of harm was
 - TA gives up margin on sales to non-TT firms
 - Non-TT firms buy instead from Navteq at a higher price
 - Non-TT firms raise their selling prices
 - Some customers of non-TT firms switch to TT
 - TT raises its prices in response to lessened competition
- There are four effects on the merged entity's profits
 - It loses the margin that it previously earned selling to non-TT firms
 - It earns a new wholesale margin on the extra sales that the merged entity makes due to consumers switching to TT
 - It earns a new retail margin on the extra sales that the merged entity makes due to consumers switching to TT
 - It earns a higher margin on the sales it would have made anyway but that it now makes at a higher price

TT/TA vertical arithmetic

- EC theory of harm was that area E + F + G was larger than area C

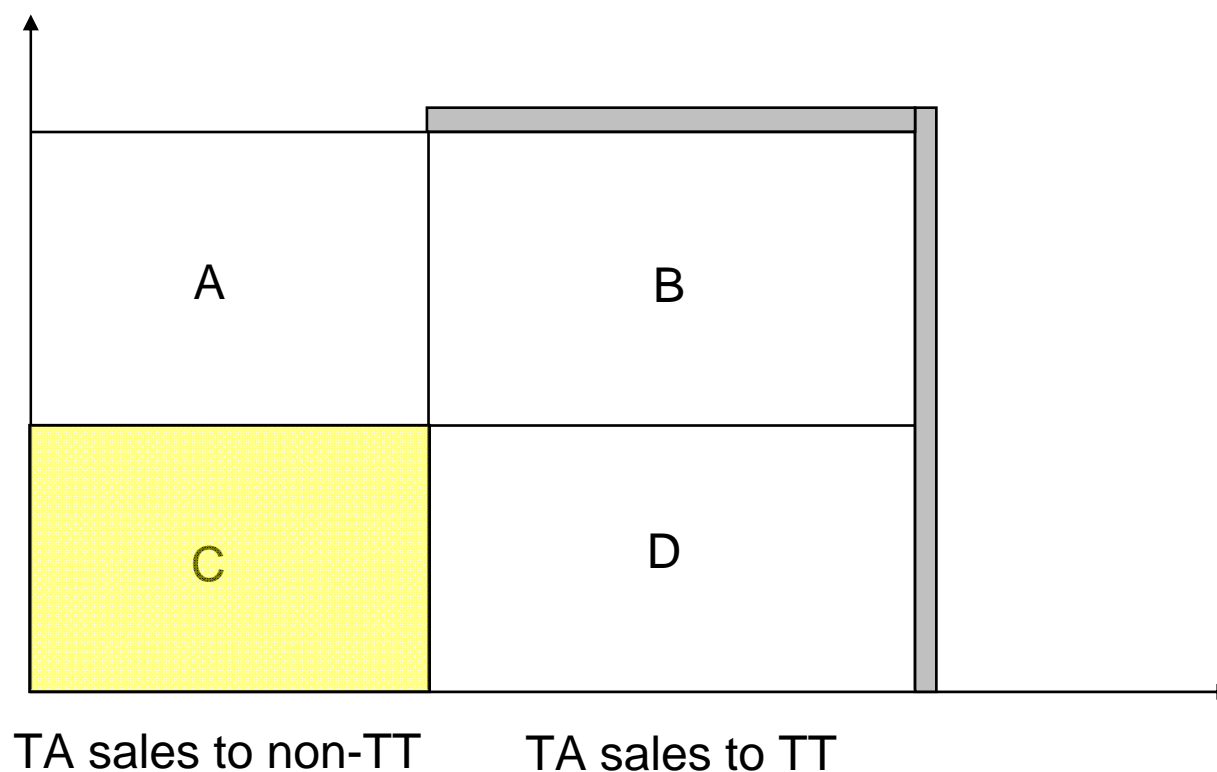


TT/TA vertical arithmetic

- The parties submitted analysis showing that areas E, F and G were small
- After extensive analysis by the Chief Economist's Team, the Commission agreed
- Important factors in the analysis were:
 - Map costs a small proportion of the total cost of a satnav, so even a significant increase in map costs would have very little effect on satnav prices
 - Even were rival satnav prices to rise, this would have little effect on TT sales
 - Econometric analysis showed cross-price elasticity between TT and its rivals was small
- Therefore the Commission concluded that the merged entity would have no incentive to foreclose

TT/TA vertical arithmetic

- This is how the Commission concluded the arithmetic would look



Harm to consumers

- **Since the Commission concluded that there would be no incentive for the merged entity to engage in input foreclosure, it concluded that the merger would not cause consumer harm**
- **In addition, the Commission accepted that the merger would lead to efficiencies**

Efficiencies in TT/TA

- **The parties argued there were two sources of efficiency from the merger**
 - “Better maps - faster”
 - Merger would allow the parties to incorporate map updates more quickly in new products
 - Pricing efficiencies
 - Merger would remove double marginalisation and so lead to price reductions
 - EC accepted this, but only after confirming that these efficiencies were merger specific (i.e. could not be achieved without the merger)

Mergers of hospitals and medical insurers

- **Possible theories of harm**

- Customer foreclosure

- Merged medical insurer would foreclose other hospitals by directing insured to own hospital
 - Economies of scale would lead to higher costs for other hospitals (or lower quality of supply)
 - Other insurers would be confronted with higher input costs or lower supplied quality and become less competitive, enabling the merged insurer to raise prices

- Input foreclosure

- Merged hospital would foreclose other insurers by limiting access to supply of healthcare (or charge higher prices)
 - Other insurers would be confronted with less input capacity or higher input costs and become less competitive, enabling the merged insurer to raise prices

Customer foreclosure

- **Does medical insurer have market power?**
- **Ability to foreclose: is medical insurer able to direct the insured to own hospital?**
 - May conflict with the medical insurer's legal obligation to arrange healthcare ("zorgplicht")
 - Increasing number of insured choosing medical insurance with free choice of healthcare providers
 - Increasing number of insured choosing a group insurance contract ("collectief contract")
 - Interdependence of hospitals and insurers
 - Quality of hospitals is gradually becoming more observable
 - Some degree of selective contracting and financial incentives by medical insurers is currently observed

Customer foreclosure (*cont.*)

- **Incentive to foreclose**

- Exclusive contracting sufficient for medical insurer with market power to damage the economies of scale of other hospitals
- Can medical insurer also appropriate all gains from market power without a merger?
- Hospital's countervailing power reduces insurer's gains from exclusive contracting, thereby increasing the incentive to foreclose

Input foreclosure

- **Does hospital have market power?**
- **Ability to foreclose: is hospital able to refuse patients from other medical insurers (or charge higher prices)?**
 - No legal obligation to serve patients of other insurers
 - Prices of hospitals' supply of healthcare partly not regulated
 - Interdependence between hospitals and insurers
 - If hospital has SMP, then NZa can impose obligation to serve patients from other insurers (on similar terms)
- **Incentive to foreclose**
 - If hospital has market power, then why does it need a merger to appropriate the gains?
 - Insurer's countervailing power prohibits hospital from increasing non-regulated prices, thereby increasing the incentive to foreclose

Efficiencies

- **Different views on significance of possible efficiencies**
- **Insurer's incentive to invest in prevention of illness may increase (if vertical integration prevents insured from switching)**
- **Less costs of negotiating and coordinating between hospital and medical insurer**
- **Pricing efficiencies (double marginalisation) may be limited as part of hospitals' supply of healthcare that is regulated**

Conclusions

- **Theories of harm more complicated and less direct than in horizontal merger cases**
- **The Commission's Non-Horizontal Merger Guidelines provide a useful framework for analysis**
 - Ability/incentive/harm to consumers
- **It is easy to tell a story of harm, so empirical evidence becomes crucial in separating the merely plausible from the likely**
 - Simple facts not helpful in TT/TA
 - Wholesale margins small relative to retail margins
 - Only one other upstream supplier of maps
- **Very important to remember that vertical mergers are more likely to be efficiency enhancing than horizontal mergers**
 - The efficiencies in TT/TA were significant
- **Theories of harm are not straightforward for mergers of hospitals and medical insurers**

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