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Anti-competitive buyer power under UK and EC merger control – too much of a good thing?

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Introduction

The main context in which buyer power is relevant to merger control analysis is assessing whether customers – particularly large customers – have the ability and incentives to resist efforts by large suppliers to increase wholesale prices above the competitive level. This issue is routinely considered in merger assessments by the European Commission, the Competition and Markets Authority (CMA) and many other competition authorities globally, and countervailing buyer power is rightly emphasised in many competition authorities' merger guidelines as a factor that may negate supplier market power.[1]

If a merged entity obtains lower input prices due to buyer power, this is generally seen by competition authorities as a rivalry-enhancing efficiency. This is because reductions in a firm's variable costs may be passed on to customers in the form of lower prices.[2] This point is highlighted in both the CMA's Merger Assessment Guidelines[3] and the European Commission's Horizontal Merger Guidelines.[4] The European Commission's Horizontal Merger Guidelines state that:

> "… *increased buyer power may be beneficial for competition. If increased buyer power lowers input costs without restricting downstream competition or total output, then a proportion of these cost reductions are likely to be passed onto consumers in the form of lower prices.*"[5]

Nevertheless, a merger that increases a customer's buyer power may have anti-competitive effects.[6] This is a topical subject for several reasons. First, this issue is increasingly considered as a matter of course in UK merger control cases and in some EC cases. In particular, in January 2018, the first UK adverse finding for over ten years (at either Phase 1 or Phase 2) on purchasing market power was reached by the CMA at Phase 1 in *European Metal Recycling/Metal & Waste Recycling*.[7]

Second, in some cases, anti-competitive buyer power may be an important competition concern in its own right. It is noteworthy that the CMA assessed this issue in some detail in its Phase 2 decision in *Tesco/Booker* (2017), reflecting the fact that it received a large body of complaints on this issue and grocery retailers have been found in previous investigations to have substantial buyer power that may have certain anti-competitive effects.[8] Similarly, this issue has also arisen in various mergers assessed by the European Commission, with the Commission reaching an adverse finding due to anti-competitive buyer power effects most recently in its Phase 2 decision in *Liberty/Ziggo* (2014). This latter case is of interest more generally as a competitor (KPN) successfully appealed the Commission's conditional clearance decision to the European General Court, and the Commission is currently reviewing the merger again.

This chapter:

- considers the circumstances in which a merger may lead to anti-competitive buyer power;
- assesses the application of various theories of harm associated with anti-competitive buyer power in the three cases referred to above, as well as some other recent UK cases that have considered the risks of anti-competitive buyer power; and
- offers some conclusions about the implications for practitioners working on future cases.

When is buyer power anti-competitive?

Anti-competitive buyer power is addressed in a mere two paragraphs of the CMA's Merger Assessment Guidelines and only three paragraphs of the European Commission's Horizontal Merger Guidelines. However, several themes can be identified from these guidelines and the economics literature relating to how mergers that increase buyer power may:

- create or enhance monopsony power, whereby a powerful customer may be able to reduce input prices by withholding demand;
- have an anti-competitive waterbed effect, where lower input prices negotiated by large buyers may lead to smaller buyers facing higher input prices, thereby harming competition in downstream markets;
- have anti-competitive effects on suppliers' incentives to invest to reduce costs or improve quality; and
- enable powerful buyers to enter into agreements with their input suppliers that foreclose competition or deter downstream entry by these suppliers.

These theories of harm are considered in turn below. The reason for describing these theories in some detail is to highlight the key economic relevant economic evidence that should be considered to assess whether these theories apply in any particular market context.

<u>Theory of harm 1: Monopsony power and withholding demand</u>

There are several definitions of buyer power. Competition authorities commonly draw a distinction between bargaining power (that is, the strength of buyers in negotiations with suppliers), and monopsony power. In its report for the Office of Fair Trading on "The competitive effects of buyer groups" (the RBB report), RBB succinctly describes monopsony power as arising where "*a large buyer purchases fewer units so as to obtain lower prices on all units it purchases*", with uniform market prices for the input rising as volumes increase and there not being bargaining or negotiation between buyers and suppliers.[9]

Given these assumptions, monopsony buyer power manifests as the mirror image of the pricing power held by a monopolist (or potentially by an oligopolist). Following the logic of a monopolist setting prices above competitive levels by withholding supply, the theory of harm involves a monopsonist (or an oligopsonist) reducing its purchase prices below competitive levels by withholding demand.[10] The key characteristic of the market structure in this case is an upstream market with a relatively fragmented supply structure (i.e. competitive suppliers) and a relatively concentrated purchaser ecosystem (i.e. a monopsony or oligopsony).

In the above case, even if an economic inefficiency arises, this would not be an inefficiency harming the consumer if the monopsonist purchaser was the final consumer of the product, because its gain from paying less per unit would exceed its loss from consuming less. On the other hand, if the purchaser was a downstream supplier itself, then its upstream exercise of buyer power could lead to restricted output and higher prices for downstream consumers, depending on downstream competition.

This monopsony scenario, in which increased buyer power may be anti-competitive, is identified in both the CMA's and European Commission's merger guidelines. The CMA's Merger Assessment Guidelines describe this issue in the following terms:

> "One circumstance in which unilateral effects may arise from increased buyer power is when:
>
> - *the merged firm has an incentive to lower the amount it purchases so as to reduce the purchase price it pays (known as 'demand withholding'); and*
> - *the merged firm also has sufficient market power over its customers so that, as it reduces the quantity sold to them in the market, it can increase the price at which it sells to them."*[11]

The European Commission's Horizontal Merger Guidelines express the issue in similar terms.[12]

However, as noted above, the monopsony model relies on the very specific assumptions outlined above. In this regard, we agree with the RBB report that:

> "*.. the monopsony model relies on a situation where, as more purchases are made, the purchasing price rises for all units. In our experience, intermediate markets are rarely characterised by this condition. It is more common for input prices to decline as purchases increase. Further, the monopsony model assumes that bargaining does not take place, yet intermediate markets are often characterised by negotiated terms of supply. Nevertheless, monopsony effects may occur in certain commodity markets where there is a uniform input price.*"[13]

<u>Theory of harm 2: Bargaining power and the waterbed effect</u>

As noted above, buyer power may also arise in a bargaining context. In a bilateral bargaining framework, both the buyer and seller may each have some bargaining power *vis-à-vis* each other. The range of prices and supply terms within which the bargain is struck will depend on the suppliers' and buyers' respective fall-back options or threat points, which are determined by what happens if they do not reach agreement. In particular, a buyer may switch to another supplier if it does not reach agreement, and thus its fall-back option may be that alternative supplier's price. A supplier, on the other hand, will either need to find another buyer (possibly at a lower price) or sacrifice the profits on this sale. Precisely where the bargain is agreed within this range depends on various other factors including: the buyer's/seller's sophistication (including their respective investments in their procurement process); the information they possess as to the position of the opposing party; their respective abilities to add value to the other side (e.g. a buyer's ability to boost the supplier's sales, such as by providing superior information on end consumer demand); and the ability and incentives of the buyer/seller to act strategically to improve their positions.[14]

The RBB report indicates that customers may have substantial buyer power where both of the following conditions apply:

- they can, at low cost, rapidly switch to credible alternative sources of supply, or develop such alternatives; and

- the buyer acts as a gateway to the market in the sense that if the supplier fails to reach agreement with that buyer, then the supplier will need to sell via inferior sales channels or forgo economies of scale.[15]

In this framework, a purchaser with high relative bargaining power can secure discounts without having to withhold demand. In this context, gateway buyers will clearly be large purchasers. However, even large purchasers do not automatically have substantial countervailing buyer power, particularly where the inputs they purchase are indispensable, they have few suppliers to choose between and/or their ability to switch suppliers is limited by supplier capacity constraints or if suppliers' products are highly differentiated. (This is obvious, as otherwise competition authorities would never reach adverse findings in relation to mergers in markets where there are only a few customers.) Moreover, smaller customers may be able to secure more competitive input prices if their purchasing requirements are less demanding (potentially enabling them to purchase from a wider range of suppliers), and they can be more opportunistic in their purchasing decisions.

In addition, upstream suppliers could behave strategically by offering the dominant buyer's rivals comparable (or even cheaper) prices to ensure that they do not become too weak. *Bedre-Defolie* and *Shaffer* (2011)[16] show that when a dominant retailer facing a competitive fringe of small retailer rivals attains significant bargaining power, the supplier could offer a lower wholesale price to the competitive fringe in order to ensure that its own outside options (i.e. selling to smaller retailers) do not deteriorate further (i.e. to prevent the dominant buyer from becoming a gateway).

If large purchasers secure lower wholesale prices for inputs, the direct effect is to reduce its downstream sales price: it can pay less to buy more (without withholding demand) and may find it profitable to sell more downstream at lower prices. Accordingly, the direct consequences of increased buyer bargaining power may benefit consumers.

Nevertheless, consumers may suffer from higher prices if there is a '*waterbed effect*'.[17] This occurs if discounts to one purchaser with greater buyer power lead to an increase in wholesale prices for that input to its rivals.

Inderst and *Valletti* (2011) consider how waterbed effects may arise in a model that assumes that buyers incur a fixed cost if they switch suppliers.[18] These fixed switching costs could include developing and marketing an own-label brand, testing that an alternative supplier's product meets the buyer's precise standards or requirements, or the costs of finding another supplier.

In their model, buyer power arises from purchase volumes, because larger buyers can spread the fixed cost of switching suppliers over a larger volume of purchases. This scale advantage leads to a large firm's threat of switching being relatively more credible, which implies that it can exert greater pressure on its suppliers to obtain discounts. The large firm can use these discounts to grow even larger at the expense of its rivals. As the smaller firms lose market share, this weakens their bargaining power (in the sense that their fixed costs of switching supplier would have to be recovered over smaller purchase volumes), resulting in their input purchase prices increasing.

However, *Inderst* and *Valletti* rightly emphasise that buyer power from purchase volumes depends on the <u>magnitude</u> of the buyer fixed switching costs. If these switching costs are sufficiently low, then there will be little scope for suppliers to price-discriminate between large and small customers, and further growth in the large buyer will reduce all retail prices.

Moreover, it is not sufficient to establish a mechanism via which one buyer's low input prices may increase the prices paid by others. One must also consider how downstream consumer prices are affected.[19] *King* (2013)[20] considers whether waterbed effects are likely in terms of downstream price increases, even if large buyers secure higher discounts from their input suppliers. King identifies three different effects that determine how downstream prices will be affected:

- The '*competition effect*' – a buyer benefiting from lower input prices sets lower downstream prices, leading to rivals reducing their own downstream prices and/or suffering a loss in sales. This reduction in rivals' downstream profits reduces the smaller firms' (derived) demand for the input, which will in turn lead to the input prices to these smaller rivals also falling. As a result, this competitive effect acts against the waterbed effect for downstream competitive rivals.
- The '*cost effect*' – in King's model, a cost effect arises as a lower input price increases total sales of the input. If marginal costs rise as output increases, then this will increase the marginal production cost to all downstream firms. However, if the upstream marginal cost of supply does not change as input volumes change, then the cost effect will be zero.
- The '*elasticity effect*' – changes in downstream prices may lead to consumers becoming less or more price sensitive, which may increase or offset the cost effect.

Based on this analysis, King emphasises two important points. First, if there is no waterbed effect, then an increase in one downstream firm's countervailing buyer power will simply reduce downstream prices to the benefit of consumers. Second, if there is a waterbed effect and downstream prices for smaller buyers increase, the benefits to one set of consumers who benefit from lower prices (i.e. those of the firm with greater buyer power) would need to be balanced against the adverse effects to consumers facing high prices from rivals facing higher input prices. Accordingly, the overall effects on consumers depend on the magnitude and interaction between these effects, including the willingness of consumers to switch between firms.

In our view, there are plausible theories of harm in which adverse waterbed effects may arise, and these issues have been explored in a number of merger cases (see further Section 3). As regards market investigations, the Competition Commission found no evidence on waterbed effects in its 2008 *Groceries* report. Similarly, in a 2014 report commissioned on the impact of modern retail on the EU food sector,[21] the European Commission found no statistical association between retail concentration at national level and product variety,[22] and found a mostly positive statistical association between retail concentration at the national level and product innovation.[23]

<u>Theory of harm 3: Bargaining power and supplier innovation</u>

Moving away from waterbed effects, another concern is how buyer power could reduce supplier innovation. This concern stems from a standard 'hold-up' perspective that suggests that a reduction in upstream suppliers' total profits due to buyer power could weaken suppliers' investment incentives.[24] In this regard, the CMA's Merger Assessment Guidelines briefly observe that:

> "*Buyer power may also lead to suppliers having lower incentives to invest in new products and processes.*"[25]

This is a clear reference to the Competition Commission's adverse finding in relation to its market investigation into the supply of groceries, which found that:

> "*Grocery retailers' buyer power is of benefit to consumers since part of the lower supplier prices arising from this buyer power will be passed on to consumers in the form of lower retail prices. We did not find that the financial viability of food and drink manufacturers was under threat as a result of the exercise of buyer power by grocery retailers. However, the transfer of excessive risks or unexpected costs by grocery retailers to their suppliers is likely to lessen suppliers' incentives to invest in new capacity, products and production processes. We concluded that, if unchecked, these practices would ultimately have a detrimental effect on consumers.*"[26]

This adverse finding was narrowly defined since it related to a certain conduct by retailers, not overall pricing levels or returns to innovation. In addition, *Inderst* and *Wey* (2011)[27] show that there are scenarios in which a strong buyer could induce a supplier to improve the competitiveness of its offering by engaging in innovation to lower costs or increase quality.

The intuition behind Inderst and Wey's model is straightforward, and follows the points made at the start of this section. The outcomes of bargaining between suppliers and buyers depend on their respective outside options; for example, from a buyer's perspective, the prices offered by rival suppliers relative to those offered by its incumbent supplier. Similarly to Inderst and Valletti (2011), Inderst and Wey assume that if a buyer switches supplier it incurs some fixed costs, but also an investment cost to achieve an optimal cost reduction. Again, this gives large buyers better outside options (and thus greater bargaining power), as they can spread these costs over a greater quantity of purchases. In this scenario, the presence of large buyers would reduce a supplier's total profits. However, crucially it could also increase the incremental profits from supplier investment, because the payoff to a sufficiently large buyer from bargaining depends solely on its outside option (i.e. its ability to switch to alternatives), while innovation that improves the appeal of the incumbent supplier's products makes switching to (higher-cost) alternatives less appealing. Furthermore, an investment that reduces the marginal cost of the supplier could reduce the value of a buyer's alternative supply options.

<u>Theory of harm 4: Bargaining power deterring entry or inducing input foreclosure</u>

A final possibility identified in the European Commission's Horizontal Merger Guidelines is that:

> "*Competition in the downstream markets could also be adversely affected if, in particular, the merged entity were likely to use its buyer power vis-à-vis its suppliers to foreclose its rivals.*"[28]

Since input foreclosure may have anti-competitive effects in downstream markets, it is a logical possibility that such concerns might also emerge if a powerful customer were to induce its suppliers not to supply essential inputs to its rivals. Powerful customers might also be able to contractually compel suppliers not to enter into competition with them in downstream markets.

Recent cases where the risk of anti-competitive buyer power has been assessed

This section considers five cases where the authorities assessed the risk of anti-competitive buyer power. These cases have been grouped under three headings: the risk of anti-competitive waterbed effects; the risk of excessive buyer power in isolation; and the risk of buyer power deterring downstream entry and leading to input foreclosure. Only one of these relates to a European Commission decision (*Liberty/Ziggo* (2014)), since this issue has been considered less often in recent EC merger decisions.

The risk of anti-competitive waterbed effects

Dawn Meats/Dunbia (2017) (UK – phase 1)

Dawn Meats and Dunbia operate abattoirs (i.e. slaughterhouses), de-boning facilities and meat processing and packaging facilities across the UK and Ireland. They are active both upstream in the purchase of livestock (sheep/cattle) and downstream in the supply of processed and unprocessed meat products – mainly beef/lamb sold to retailers, hotels, restaurants, caterers and food manufacturers.[29]

The CMA investigated whether increased buyer power could create a waterbed effect, whereby the merged entity negotiates lower prices (or worsens other terms) for livestock from suppliers, leading to those suppliers recouping the losses from the parties' competitors. Competitive harm would arise if this resulted in competitors exiting the market or otherwise reducing operations such that there was softer competition in the supply of processed and unprocessed meat. This could therefore offset any pro-competitive effects from an increase in buyer power (e.g. passing cost savings into lower prices to downstream customers).[30]

The evidence suggested that the parties had modest shares of purchasing at the national level (GB), with shares below 20% for both sheep and cattle. In Northern Ireland (NI), the shares were redacted but the CMA concluded the merger would not raise the parties' buyer power *vis-à-vis* sheep. However, the CMA did believe that the parties accounted for a significant proportion of demand for cattle in the North West of England.

The low GB-wide shares of purchasing are consistent with many alternative competitors for the acquisition of sheep/cattle at a national level – with at least nine large purchasers and several small local abattoirs for each meat species. There were still three purchasers in the North West of England, and at least eight in NI, who would constrain the parties post-merger. Additionally, there is significant spare capacity for additional slaughter at the national level (shares redacted), and around 62-76% capacity utilisation throughout the island of Ireland. Accordingly, the CMA concluded that it would be difficult for the parties to leverage their buyer power even at the regional level, particularly as farmers were willing to travel up to 200 miles.[31]

Finally, the CMA considered internal documents suggesting the parties could secure significant savings on the price of cattle. However, given the CMA's view that there was no significant increase in the parties' buyer power and farmers were able to switch supply quickly and easily, the CMA dismissed the theory of harm and cleared the merger.[32]

Cargill/Faccenda (2018) (UK – phase 1)

Cargill and *Faccenda* entered a joint venture (JV), overlapping in the supply of fresh and value-added chicken to various customers, including retailers, caterers and food manufacturers in the UK. The CMA's analysis considered competitive harm associated with potential waterbed effects from the parties' increased buyer power when acquiring broiler chickens from 'grow-out' farms. However, the CMA noted that several cumulative conditions would need to be met:

(a) the JV needed to negotiate better terms from 'grow-out' farm suppliers;

(b) better terms (i.e. lower prices) are then passed on to customers, attracting business away from competitors supplying chicken downstream;

(c) the loss of customers among rivals downstream is sufficiently harmful such that it causes exit, or increases the cost to service remaining customers; and

(d) the lessening in competition downstream increases the JV's ability to increase prices or worsen terms in the long term (with entry or expansion by remaining competitors not sufficient to negate such effects).

The CMA concluded that the JV was not in a strong position to negotiate better supply terms with the 'grow-out' farms for several reasons:

(a) The lack of volume discounts to poultry suppliers.

(b) The parties' combined low market share (0-10%).

(c) Grow-out farms having at least one outside option they could switch to if the parties tried to offer worse terms.

(d) An effective cap on negotiating strength posed by the mutually dependent relationship between farms and chicken suppliers. One farmer noted that they would simply stop producing chickens if margins were not sufficient.

(e) Individual firms tend to only supply one of the parties (for health and safety reasons). Therefore, the parties did not have common grow-out farm suppliers, and a theoretical increase in the JV's buyer power would not affect the pricing to other suppliers.

(f) The JV had modest shares of supply in fresh or fresh added-value chicken (less than 25%), and there were several credible suppliers who supply similar customers.

Finally, when contacted by the CMA, neither farmers nor the National Farmers' Union expressed concerns about the merger. Consequently, the CMA dismissed the waterbed theory of harm and cleared the merger.

Tesco/Booker (2017) (UK – phase 2)

The merger between *Tesco* and *Booker* likely needs little introduction. In 2017, Tesco, as the UK's largest supermarket chain, purchased Booker, the UK's largest grocery wholesaler servicing retailers and caterers via delivery and cash & carry services.

The merger was between firms at different levels of the supply chain (i.e. a vertical merger), which the CMA generally accepts are competitively benign.[33] As noted in Section 2, increases in buyer power are also likely to be viewed as pro-competitive if lower prices from better-negotiated terms with suppliers are likely passed on to customers. However, the CMA received many third-party complaints alleging the merged entity would receive more favourable terms from suppliers – either through harmonising prices across suppliers,[34] or a general increase in buyer power. Third parties also suggested that the terms could extend to non-price aspects including access to products during periods of peak demand, or exclusive product access or product format (e.g. price-marked packs), to the detriment of other wholesalers. They were also concerned that the merged entity would likely stock fewer branded products favouring its own-brand goods, consequently reducing supplier innovation. Thus, the CMA felt it needed to address third-party concerns that the merged entity's buyer power would lessen competition in the market for grocery wholesale services.

The CMA identified a series of conditions that would all need to be satisfied for this theory of harm to apply:

- the merged entity negotiates better terms with its suppliers;
- lower input prices are then passed through to retailers and caterers, allowing the merged entity to attract business from competitors;
- competition from wholesalers would be weakened through wholesalers either exiting the market, or remaining but facing increased costs from suppliers via a 'waterbed effect'; and

- the merged entity can therefore raise prices or otherwise worsen its offer in the long term due to weakened delivered and/or cash & carry grocery wholesale (with no countervailing effects from entry/expansion).[35]

The CMA was confident that any efficiency savings would arise quickly, while competitive harm would only occur in the less foreseeable, long term.

The CMA assessed this theory in two stages as follows:

- *Whether the merged entity may negotiate better supply terms and will pass them on*

  Whether the merged entity could negotiate better supply terms depends, unsurprisingly, on how it negotiates with suppliers. The CMA therefore considered detailed evidence on supplier procurement practices, cost synergies, the parties' share of procurement and the increment in its share across product categories, and their overall share of both grocery and wholesale retailing.

  The evidence suggested that "*the merged entity will not have materially stronger bargaining power in tobacco or any other products following the Merger*".[36] This was because the procurement increment was relatively low, and tobacco suppliers were likely to gain bargaining power due to high supplier concentration – constraining any ability for the merged entity to exercise its own increase in buyer power.

  Given its view that the merged entity did not have appreciably greater buyer power, the CMA went on to assess the effect of price harmonisation on competition.

- *Will competition become weaker?*

  Assuming the parties could achieve some savings through price harmonisation, the CMA found that this would only affect a small proportion of Booker's grocery purchases. Booker's share of wholesaling is also relatively low (18%), and the CMA would not expect a firm in this position to be able to lessen competition across the whole marketplace. As regards the waterbed effect (i.e. rival wholesalers receiving worse terms), while some suppliers said they might seek to recoup profit lost from the merged entity, the argument suffers from a very logical counterpoint: if suppliers can charge weak buyers higher prices before the merger, why did they not do so? This argument therefore held little weight with the CMA.

  Based on its analysis of competitive conditions in grocery wholesale and the options available to wholesalers after the merger, the CMA concluded that it is unlikely that the merger would weaken competition, with competitors continuing to act as a constraint on the merged entity. The CMA's final point is also worth repeating: "*we note that it would generally be against the principles of merger control to find that a merger gives rise to a likely SLC* [substantial lessening of competition] *just because it made one or both parties more efficient and a stronger competitor*".[37] Thus, there was no SLC from the merged entity's increase in buyer power.

Excessive buyer power alone – European Metal Recycling/Metal & Waste Recycling (2018) (UK – phase 1)

This was a merger between two purchasers of ferrous and non-ferrous scrap metal, which they then shredded or processed for selling to end-users (e.g. steel manufacturers). This merger follows further consolidation in the market for scrap metal, with European Metal Recycling (EMR) recently purchasing five sites from SITA in 2014, and Sims merging with Dunn in 2011.

This case is particularly striking for two reasons. First, it is the first case for over ten years where an adverse finding has been reached at either phase 1 or phase 2 relating to anti-competitive buyer power. Second, the CMA did not reach any finding in relation to the supply of ferrous or non-ferrous metal in the UK, because the parties' combined shares of supply were not of a level that raised concerns (respectively, 30-40% and 20-30%, with small increments of 0-5%).

The main competition concerns resulted from the merging parties purchasing ferrous and non-ferrous scrap metal in South Wales, the West Midlands, the North East, and London. The CMA found fairly low combined shares of purchasing in both South Wales (30%) and the West Midlands (40-50%), while in the North East the parties were not close competitors despite high shares of purchasing (70-80%). This focused attention on London, where the parties had a combined purchasing share of 60-70%, with an increment of 5-10%.

In London, there would be only one significant competitor in the region (S Norton) post-merger that could constrain the parties, with the parties competing particularly closely when purchasing waste scrap metal from industrial sources. Accordingly, the CMA concluded that the merger gives rise to a realistic prospect of an SLC in the purchase of scrap metal in London.

The CMA also reached an adverse finding in relation to the shredding of waste metal in the Hitchin area, where the merged entity's market share of purchases would increase by 20-30% to 50-60%.

The CMA's reference decision makes no reference to the Office of Fair Trading's (OFT) analysis in *Sims/Dunn* (2011), which related to the same markets. In particular, in *Sims/Dunn* the OFT similarly found that the merged business' share of scrap metal purchases may have been high in certain regions (although there was uncertainty in the data), and some third parties raised concerns about the merged entity's buyer power in these regions. However, in contrast to *European Metal Recycling/Metal & Waste Recycling*, but in line with the Merger Assessment Guidelines (as discussed above in Section 2), the OFT stated that:

> "*Generally, an increase in buyer power as a result of a merger is not likely to give rise to unilateral effects. However, unilateral effects may arise from anticompetitive buyer power when: (i) a merged firm has an incentive to reduce the amount it purchases (of scrap from scrap merchants, in this case) so as to reduce the purchase price; and (ii) also has sufficient market power over its customers so that, as it reduces the quantity sold to them in the market for the trade of scrap, it can increase the selling price there.*"

The OFT's analysis then focused first on the second limb, since the merged entity's market shares in the downstream markets were too low (no higher than 10-20%, depending on the metal considered) for there to be any scope for the merged entity to increase national scrap prices to its customers. The CMA's later decision, however, makes no reference to this point.

As regards the first limb, the OFT found that:

- the increase in Sims' purchases was likely to be low at 0-10%;
- scrap merchants may sell outside their regions if prices paid were to fall; and
- no regional scrap merchants had expressed any concerns, and transparency of international processed scrap metal prices may negate any regional buyer concentration.

The CMA clearly reached opposing views as to the increase in buyer power in *European Metal Recycling/Metal & Waste Recycling*.

The CMA's reference decision appears to attach considerable weight to the fact that an absence of purchasing competition could adversely affect the interest of local authorities and consumers, but there is no indication that these groups represent a high share of the scrap metal purchased by the parties. The case is still being considered by the CMA at Phase 2, with a provisional decision expected in May 2018 and a final decision in July 2018.

Anti-competitive buyer power deterring downstream entry and leading to input foreclosure – Liberty/Ziggo (2014) (EC phase 2)

Introduction

Liberty is an international operator of cable networks, offering internet, television, fixed telephony and mobile services in 11 EU member states and Switzerland. Liberty is active in the Netherlands through its cable network subsidiary UPC, which distributes the Pay TV channels Film1 and Sport1. In 2014, Liberty acquired Ziggo, a broadband cable network company covering more than half of the Netherlands. Its services include digital and analogue cable video, broadband internet, mobile telecommunications and digital telephony (VoIP) services.

The Commission considered that the merger raised two main potential competition concerns:

- in the possible market for wholesale supply and acquisition of Premium Pay TV film channels and the market for wholesale supply and acquisition of Premium Pay TV channels; and
- in the downstream market for the retail supply of Pay TV services.

We focus here on the first of these issues, namely the merged entity's purchasing of both Premium Pay TV and Pay TV film channels, and the impact on wholesale suppliers. The main concern was that the combined Liberty and Ziggo would control (60-70%) of Pay TV subscribers in the Netherlands. In the Commission's view, this had the potential to impede effective competition through strengthening the merging parties' buyer power on the upstream markets for the supply and acquisition of Basic and Premium Pay TV channels.

The Commission structured its investigation by first investigating whether the transaction increased the merged entity's buyer power *vis-à-vis* TV broadcasters, then investigating four specific theories of harm. We mirror this structure in our discussion below.

Effect of the transaction on the merged entity's bargaining power *vis-à-vis* broadcasters

The merging parties purchase Pay TV packages (both basic and premium) that they then offer their customers. The merged entity would account for 50-60% of the market for the acquisition of Pay TV channels, with a sizeable (10-20%) increment. The Commission also notes that these shares are likely to understate the buying power of the combined entity, due to their significant market position in retail Pay TV services (which is closely related to the number of households served).

In its assessment of bargaining power, the Commission considered a range of evidence including:

- That there was a negative correlation between the price paid by TV service providers per TV household to TV broadcasters and the number of households served by the TV service providers. In other words, as a provider services more households, their bargaining power increases and they are able to negotiate a better 'per subscriber' rate with broadcasters.
- The merged entity would control at least twice (if not three times) as many households as the next largest provider (KPN). This is consistent with the share of spending of broadcasters' TV channels being significantly smaller than the share of revenue generated from selling those TV channels (i.e. they pay less 'per subscriber' than rivals).

- Internal documents confirmed that Liberty was paying under the average market cost for TV channels (percentage redacted), while others verified the close link between the number of household subscribers and the market power exerted on upstream suppliers (specific documents are redacted).
- Submissions from the TV broadcasters noting that large retail TV providers hold the most bargaining power and the merger would increase that bargaining strength, allowing the merging parties to dictate their prices and other conditions.

Following this evidence, the Commission went on to consider four specific theories of harm relating to how increased buyer power for the merging parties may:

(a) "Increase its ability and incentive to hamper the emergence of innovative Pay TV services;

(b) [i]ncrease its ability and incentive to negatively influence the breadth and quality of the programming content that broadcasters offer in the Netherlands;

(c) [i]ncrease its ability and incentive to obtain terms and conditions from broadcasters that ultimately have a negative impact on the access of competing retail TV providers to that very same content; and

(d) [i]ncrease its ability and incentive to block TV broadcasters' hybrid broadcast broadband TV signals."[38]

We consider the four theories and the specific evidence and conclusions in the following sections.

<u>Effect of increased bargaining power on the emergence of OTT services</u>

This theory of harm deals specifically with the potential threat the merged entity's increased buyer power could have on product innovation. In particular, TV broadcasters have been offering content not only via Pay TV channels but also over the internet via Over the Top (OTT) services. It is common for retailers to negotiate restrictions in content contracts that prevent them from offering the same content via the internet. The intuition for this is relatively simple; if consumers could view the same content for free via the internet, they would be much less likely to subscribe to Pay TV services. This, in turn, would reduce the demand for such content and its value to both retailers and broadcasters.

Therefore, the Commission assessed whether the merger would allow the merging parties to either sustain these restrictive agreements or negotiate agreements that were even more onerous (to the detriment of broadcasters and ultimately consumers).

There are three main distribution channels for TV content. First, including that content in linear TV channels offered to retail TV service providers. Second, offering the content in a non-linear fashion to the same retail providers, but for their Video on Demand (VOD) services. Third, offering content over the internet (either directly or via an aggregator – e.g. Netflix). This third form of distribution is a relatively new way to distribute content and is growing in importance in the Netherlands. If unhindered, it would likely form a growing competitive constraint on the first two (more traditional) distribution models.

The Commission investigated the link between Pay TV and OTT services in detail, finding that Pay TV and OTT services are typically negotiated and acquired jointly between broadcasters and the parties. Thus, the Commission concluded that there was a strong direct link between the merged entity's market power in acquiring Pay TV channels and their ability to influence how broadcasters distribute their TV channels and content over OTT services.[39]

The Commission concluded that the market was already subject to agreements restricting the ability of broadcasters to offer content via OTT services. However, until now, some TV broadcasters had been able to resist such agreements, while others had 'watered down' their restrictive nature. The Commission therefore investigated both the ability and incentive of harm to OTT innovation via restricting OTT services:

- Ability via contractual means – The Commission concluded that the parties would have a greater ability to prevent, delay or hamper OTT innovation via contractual means, even accounting for countervailing factors including broadcasters co-ordinating market responses and facilitating entry downstream.
- Ability to technically restrict OTT services – The Commission concluded that the parties have the technical ability to shut down or degrade OTT services via access to their internet networks services.

The Commission therefore concluded:

> "*[T]he proposed transaction would confer upon the merged entity an increased degree of buyer power vis-à-vis TV broadcasters in the Netherlands. This would increase its ability to impose contractual terms on TV broadcasters that prevent, hamper or delay, by direct and indirect means, the OTT services that include those broadcasters' content. The increased ability to do so would be compounded by the fact that the Parties already have the technical means at their disposal to shut down or to degrade the access to their Internet networks, which these OTT services will need to reach the merged entity's broadband customers*."[40]

The Commission also concluded that the transaction would likely increase the existing incentive to prevent or hamper OTT services. In combination with the ability noted above, this would likely lead to the merger parties adopting a strategy that prevents, hampers or delays OTT innovation post-merger.[41]

Finally, the Commission looked at the likely negative effects on competition from OTT providers resulting from the merged entity using their increased buyer power. They concluded that the merging parties would likely restrict broadcasters' content over the internet and foreclose its potential and existing retail rivals for Pay TV services (particularly innovative OTT service providers such as Netflix, but also smart TV providers like Samsung and Sony). Further, and as noted above, restricting access to OTT service providers would likely prevent further competition and innovation in the retail market for Pay TV services – depriving Dutch consumers of those benefits. Without these constraints, existing Pay TV providers will be less constrained in price setting, likely leading to consumer harm.

Therefore the Commission found:

> "*[T]he proposed transaction is unlikely to be compatible with the internal market in that it is likely to significantly impede effective competition on the market for the acquisition of Pay TV channels, on the market for the retail provision of Pay TV services or on the hypothetical market for the retail provision of multiple play services.*"[42]

Ability and incentive of the Notifying Party to use its increased buyer power to foreclose TV broadcasters' competing content from having access to its Pay TV distribution platform

Another theory of harm related to the merging entity using their increased buyer power to restrict TV broadcasters from using the merged entity's Pay TV distribution platform (i.e. to foreclose particular TV channels). The particular concern was around thematic channels (i.e. channels with a focus on one topic – e.g. history or cooking), and whether the merging party would have the ability and incentive not to carry broadcasters' thematic channels.

The Commission considered that ability was reasonably clear, although the Commission did note that recent OTT developments (e.g. VOD TV) would provide different routes to customers, so ability to prevent distribution could be undermined over time. However, the parties' incentive not to carry depends on the specific content and whether that is in direct competition with the merged entity's own content. A non-competing channel could well enrich the merged entity's TV offering, allowing it to attract a broader base of subscribers.

However, the merging entity's commitments would also reduce its buyer power in the acquisition market for TV channels. Therefore, the Commission did not need to conclude on this point, given that the parties' commitments would eliminate any potential adverse effects on competition.

Ability and incentive of the Notifying Party post-merger to use its increased buyer power to foreclose its rivals in the retail market for the provision of Pay TV services

As concluded above, the merged entity was found to have an increase in bargaining power *vis-à-vis* TV broadcasters. The Commission therefore investigated whether this buyer power could:

(a) force broadcasters into exclusivity agreements in exchange for increased licence fees – limiting channel availability;

(b) thereby lead broadcasters to charge higher fees to the merged entity's downstream competitors (i.e. impeding competition via a waterbed effect).

On point (a), TV broadcasters were adamant during the investigation that higher fees could not compensate for exclusively. They rely heavily on advertising income, which requires TV channels to have a national reach (in most cases greater than 90% of Dutch households). On point (b), the waterbed theory of harm arises through buyer power leading to higher licence fees paid by the merging parties' competitors downstream of TV broadcasters. These higher costs would then have to outweigh any positive benefits to consumers from the lower licence fees paid by the merging parties. However, the Commission (like the CMA as noted above) was not convinced by this argument, particularly as, if the TV broadcasters are in a position to negotiate higher licence fees post-merger, why did they not do so pre-merger? There was also no evidence to suggest that rivals would pay higher licence fees as a result of the merger.

Therefore, the Commission concluded that "*the proposed transaction would not significantly impede effective competition in so far as it is unlikely to confer upon the Notifying Party the ability and the incentive to engage in input foreclosure vis-à-vis its downstream rivals*".[43]

Ability and incentive of the Notifying Party post-merger to block TV broadcasters' Hybrid Broadcast Broadband TV signals

Hybrid Broadcast Broadband TV (HbbTV) signals (triggers) allow TV broadcasters to allow retail TV customers who have a smart TV to connect directly to the broadcasters' own OTT services. However, neither Liberty nor Ziggo allowed triggers on its network pre-merger, with both actively engaging in blocking HbbTV signals on their cable networks. Therefore, the Commission concluded that both parties already engage in such a strategy, and any ability or incentive is not merger-specific. Consequently, there was no impediment to effective competition on this basis.[44]

Conclusions

To sum up, several theories of harm can be advanced as to how buyer power can have anti-competitive effects and lead to higher prices to consumers. In our view, monopsony models only apply in very specific circumstances. Economic models also explain how substantial bargaining power can lead to anti-competitive waterbed effects. However, it is important to assess whether these models fit the facts of the market in question.

The fact that such waterbed theories of harm are not reflected in either the European Commission's or CMA's merger guidelines is likely because these theories of harm were still somewhat novel when they were written,[45] but the possible existence of waterbed effects has been assessed in several cases.

Finally, in certain circumstances, it should be noted that powerful purchasers may be able to restrict supplier entry and engage in input foreclosure. *Liberty/Ziggo* (2014) provides an important illustration of this mechanism.

* * *

Endnotes

1. See paragraphs 9-233 to 9-239 of Parr, Finbow and Hughes, *UK Merger Control: Law and Practice*, November 2016, 3rd Edition, Sweet & Maxwell.
2. See, for example, the CMA's Phase 2 decisions in *Tesco/Booker* (paragraph 8.10) and *Poundland/99p* (2015) (paragraph 6.95). The factors influencing the pass-through of merger-specific cost savings and the assessment of efficiencies is considered more generally at paragraphs 9-240 to 9-270 of Parr, Finbow and Hughes, *op cit*, note 1.
3. Competition Commission and Office of Fair Trading, "Merger Assessment Guidelines", September 2010, CC2/OFT1254, paragraph 5.4.19. These guidelines have been adopted by the CMA and are referred to as the Merger Assessment Guidelines in this chapter.
4. European Commission, "Guidelines on the assessment of horizontal under the Council Regulation on the control of concentrations between undertakings", OJ C31, 5 February 2004, paragraph 62.
5. European Commission, Horizontal Merger Guidelines, paragraph 62.
6. This chapter draws heavily on the analysis of the potential anti-competitive effects of increased buyer power set out at paragraphs 9-134 to 9-136 of Parr, Finbow and Hughes, see note 1.
7. This case is still subject to Phase 2 review by the CMA. As at the time of writing, the last adverse finding at phase 2 in the UK on the basis of purchasing market power was *Stonegate/Deans* (2007).
8. In particular, the Competition Commission's 2008 *Groceries* report led to the establishment of the Groceries Code Adjudicator, which is the independent regulator ensuring that the ten largest UK supermarkets treat their direct suppliers lawfully and fairly.
9. RBB Economics, "The competitive effects of buyer groups" (OFT Economic Discussion Paper OFT863), January 2007, paragraph 1.16.
10. This is the consequence of a monopsonist having a higher marginal factor cost compared to a competitive purchaser (similar to a monopolist having a lower marginal revenue compared to a competitive supplier). See OECD – *Monopsony and Buyer Power*, DAF/COMP(2008)38, 2009.
11. CMA Merger Assessment Guidelines, paragraph 5.4.20. The CMA cites the Competition Commission's decision in *Stonegate/Deans* (2007) as an illustration of demand-withholding. In this case, the Competition Commission stated that it was concerned

about the monopsony buying power of the merged company, and concluded that: "*Lower prices to producers of eggs could benefit consumers if passed on to them but we believe it would ultimately result in a reduction in the quantity of eggs produced and so would raise prices to retailers and final consumers. Hence, in our view the merger may be expected to a result in a SLC in the procurement of shell eggs from producers.*" (paragraph 21).

12. The European Commission's Horizontal Merger Guidelines indicate that: "*… a merger that creates or strengthens the market power of a buyer may significantly impede effective competition, in particular by creating or strengthening a dominant position. The merged firm may be in a position to obtain lower prices by reducing its purchase of inputs. This may, in turn, lead it also to lower its level of output in the final product market, and thus harm consumer welfare. Such effects may in particular arise when upstream sellers are relatively fragmented.*" (Paragraph 61).
13. *Op cit*, note 9.
14. These issues are discussed further at paragraphs 9-23 to 9-25 of Parr, Finbow and Hughes, *op cit*, note 1.
15. *Op cit,* note 9, paragraph 1.22.
16. Bedre-Defolie, O. & Shaffer, G. – "Countervailing power hypothesis and anti-waterbed effects", ESMT Berlin Working Paper, 2011.
17. See Dobson, P.W. & Inderst, R. – "Differential buyer power and the waterbed effect: do strong buyers benefit or harm consumers?", *European Competition Law Review*, 2007. There are also several dynamic theories of harm of excessive buyer power. For example, Inderst and Shaffer (2007) specify a model where a horizontal merger makes it easier for the merged retailer to adopt a single-sourcing strategy to increase its buyer power. This, in turn, incentivises wholesalers to strategically reduce their product differentiation, which reduces consumer welfare by reducing product variety.
18. Inderst, R. & Valletti T.M. – "Buyer power and the 'waterbed effect'", *The Journal of Industrial Economics* (39/1, pp. 1-20), 2011.
19. Although this is essential to any coherent theory of harm. For example, it is not sufficient to assert that if a supplier lowers its prices to one (large) buyer, then it must increase prices to others to recover its costs. This is because such arguments based on cost recovery fail to address why a supplier did not increase its prices to other buyers beforehand.
20. King, S.P. – "Countervailing power and input pricing: when is a waterbed effect likely?", *International Journal of the Economics of Business* (20/3, pp. 325-340), 2013.
21. European Commission – "The economic impact of modern retail on choice and innovation in the EU food sector – final report", 2014.
22. European Commission (2014), *op cit*, note 22, p. 207. The Commission found no statistically significant relationship between retail concentration at national level and product variety/product size variety. At local level (e.g. number of different retailers in a town), it found a weak and negative relationship between retail concentration and product size variety (albeit the magnitude of this effect was small).
23. European Commission (2014), *op cit*, note 22, p. 210. The Commission found a statistically significant and positive relationship between retail concentration at the national level and the number of new products, new range extensions and a measure of innovation named 'Opus innovations', but a negative relationship regarding the number of new packaging introduced. The latter negative relationship was also observed as regards new packaging and retail concentration at the local level.

24. For a paper formalising this concern, see Battigalli, P., Fumagalli, C. and Polo, M. – “Buyer power and quality improvement”, *Research in Economics* (61, pp. 45-61), 2007.
25. CMA Merger Assessment Guidelines, paragraph 5.4.21.
26. *Groceries*, paragraph 36.
27. Inderst, R. and Wey, C. – “Countervailing power and dynamic efficiency”, *Journal of the European Economic Association* (9/4, pp. 702-720), 2011.
28. European Commission’s Horizontal Merger Guidelines, paragraph 61.
29. *Dawn Meats/Dunbia*, paragraph 3.
30. *Dawn Meats/Dunbia*, paragraph 72.
31. *Dawn Meats/Dunbia*, paragraph 58.
32. *Dawn Meats/Dunbia*, paragraph 72.
33. CMA Merger Assessment Guidelines, paragraph 5.6.1.
34. This refers to moving supply of both parties’ products to either Tesco or Booker’s suppliers, depending on who had negotiated the better terms pre-merger.
35. *Tesco/Booker*, paragraph 8.11.
36. *Tesco/Booker*, paragraph 8.51.
37. *Tesco/Booker*, paragraph 8.74.
38. *Liberty/Ziggo*, paragraph 277.
39. *Liberty/Ziggo*, paragraph 320.
40. *Liberty/Ziggo*, paragraph 394.
41. *Liberty/Ziggo*, paragraph 398.
42. *Liberty/Ziggo*, paragraph 409.
43. *Liberty/Ziggo*, paragraph 439.
44. *Liberty/Ziggo*, paragraph 448.
45. Note that the European Commission’s Horizontal Merger Guidelines were published in 2004 and the UK Merger Assessment Guidelines in 2010.

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