SHOULD PROFIT MARGINS PLAY A MORE DECISIVE ROLE IN HORIZONTAL MERGER CONTROL? – A REPLY TO VALLETTI AND ZENGER

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Key points

- Margin analysis should play an important role in merger control.
- Measuring margins is a complex exercise and comparing margins across markets is especially problematic.
- There is no justification for the adoption of a policy that targets mergers in high-margin industries.
- While margins in western economies have increased in recent decades, this does not justify a radical change in merger control policy.
- There is no justification for a policy that targets high-margin firms especially.

I. INTRODUCTION

In this brief article I provide a few comments on the rejoinder published in this journal[2] by Prof Tommaso Valletti and Dr Hans Zenger in which they discuss the main conclusions of my assessment of the appropriate role of margin analysis in horizontal merger control, also published in this journal.[3] My goal here is twofold. Firstly, I intend to clarify our points of agreement and disagreement. Secondly, I provide further argumentation in defence of my views on those issues where we are not aligned.

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[2] T Valletti & H Zenger, 'Should Profit Margins Play a More Decisive Role in Horizontal Merger Control? – A Rejoinder to Jorge Padilla', *Journal of European Competition Law & Practice* (in press).

[3] J Padilla, 'Should Profit Margins Play a More Decisive Role in Horizontal Merger Control?', *Journal of European Competition Law & Practice* (in press).

The paper is structured in two sections. In section II I set out the points of agreement between us, which are many and fundamental. In Section III I identify our main disagreements, which are few but non-trivial, and put forward additional arguments in support of the central claim of my first paper: while profit margins should play, and do play, a role in the assessment of the potential price effect of horizontal mergers, there is no justification for the adoption of a policy that targets mergers in high-margin markets or high-margin firms and subjects them to stricter controls. Section IV concludes.

II. POINTS OF AGREEMENT

Margin analysis should play an important role in merger control. I agree with Prof Valletti and Dr Zenger that "the size of the merging firms' margins is bound to have an impact on the likely competitive effects of a merger" and that "[a]ll else equal, a merger between firms with high margins will therefore cause greater anticompetitive effects".[4]

Measuring margins is a complex exercise. Prof Valletti and Dr Zenger appear to agree with (many of) the following statements from my original paper:

a) "One should be careful with identification, since the right margin to consider will not always be the short-run contribution margin;
b) One should be careful with measurement and perform sensitivity checks, since otherwise one runs a risk of drawing wrong conclusions;
c) Comparing margins across industries is complicated, and hence a specific targeting of high margin industries may lead to enforcement errors by identifying the wrong sectors".[5]

There is no justification for the adoption of a policy that targets mergers in high-margin industries. They also appear to agree with this statement, which was one of the three key policy propositions I made in my paper. Indeed, they note: "we have not proposed to specifically "target" certain industries for enforcement action on account of their high margins".[6]

While margins in western economies have increased in recent decades, this does not justify a radical change in merger control policy. I concur with Prof Valletti and Dr Zenger that "margins in western economies have not remained stable over time" and that "empirical research has shown that recent decades have been characterized by a … trend towards increasing

[4] See Valletti and Zenger, op. cit., supra note 2 at 3 and Padilla, op. cit., supra note 3 at 4.
[5] See Valletti and Zenger, op. cit., supra note 2 at 9 and Padilla, op. cit., supra note 3 at section IV.
[6] See Valletti and Zenger, op. cit., supra note 2 at 9 and Padilla, op. cit., supra note 3 at section IV.

profit margins".[7] Likewise, I agree that there are different explanations for this phenomenon, including weak merger enforcement in the past. But, as Prof Valletti and Dr Zenger state, "[i]t is therefore by no means obvious that past competition enforcement has caused the surge in the share of output accruing to firm profits rather than labour".[8] It is for this reason that I concluded that the evidence is not so clear cut as to trigger a radical change in merger control policy […]".[9] Prof Valletti and Dr Zenger also "agree with this statement",[10] which was the second of the three key policy propositions I made in my original paper.

III. POINTS OF DISAGREEMENT

Alas, Prof Valletti and Dr Zenger and I are not in full agreement. Though the points of disagreements are few in number, they are anything but trivial. Most importantly, Prof Valletti and Dr Zenger disagree with the last of the three policy propositions in my original paper: there is no justification for a policy that targets high margin firms especially.[11]

In their opinion, responsible competition authorities cannot ignore that "[c]oncentrations through merger are more problematic when the pricing power of the merging firms is large to begin with".[12] In practical terms, according to Prof Valletti and Dr Zenger,

- Competition authorities should factor in their merger control assessments that "[a]ll else equal, a merger between firms with high margins will therefore cause greater anticompetitive effects". [13]

- Merger control should also be concerned about "high margins in their own right. E.g., if one of the merging parties is a strong incumbent with correspondingly large mark-ups, then its acquisition of a smaller challenger may cause competition concerns even if the immediate price effect of the transaction is relatively small".

As explained above, I do not disagree with the first statement. When the margins of the merging parties are high, the value of sales recaptured through the merger is also high and, other things equal, the merger is likely to cause a higher price increase.

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[7] See Valletti and Zenger, op. cit., supra note 2 at 4 and Padilla, op. cit., supra note 3 at 12.
[8] See Valletti and Zenger, op. cit., supra note 2 at section III.D.
[9] See Padilla, op. cit., supra, note 3 at 7.
[10] See Valletti and Zenger, op. cit., supra note 2 at 10.
[11] See Padilla, op. cit., supra, note 3 at 15.
[12] See Valletti and Zenger, op. cit., supra note 2 at 12.
[13] See Valletti and Zenger, op. cit., supra note 2 at 3 and Padilla, op. cit., supra note 3 at 4.

However, I strongly disagree with the second statement. The merging parties' margins may be high because their products are highly differentiated, i.e. their respective diversion ratios are low, in which case a merger between them need not produce price increases and consumer harm. In particular, I disagree with their call to protect competitor and rivalry even when the merger produces no "immediate" consumer harm. In the absence of evidence that the small competitor exerts, or will be able to exert, an effective competitive constraint in the future, I see no reason to block or condition a merger and, if that evidence is available, the profitability of the acquiring party seems largely irrelevant.[14]

Prof Valletti and Dr Zenger refer to the Horizontal Merger Guidelines from 2004 to support their claim that "price increases resulting from a merger ***are*** more likely when the merging firms' margins are significant already prior to the transaction".[15] But, to the best of my recollection, all those guidelines say is that "[h]igh pre-merger mergers ***may also*** make significant price increases more likely".[16] In other words, the 2004 Horizontal Merger Guidelines support the first claim by Prof Valletti and Dr Zenger, which I concur with, but not the second.

Prof Valletti and Dr Zenger also refer to the recent literature on merger retrospectives to support their second claim.[17] This literature has shown that many mergers which were cleared (possibly with conditions) resulted in price

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[14] In a personal communication, Prof Valletti and Dr Zenger wrote to me explaining that "As a competition authority, we will typically be interested in relative changes in market power brought about by a merger. That is, there must be an appreciable comparative effect for us to worry (e.g., prices increasing by more than a certain percentage). This notwithstanding, it would be wrong in our view not to look at absolute levels of pre-merger market power and solely focus on the relative size of increments. Rather, we think one should also be concerned about some small increases in market power if the absolute level of pre-merger market power is already exceptionally high. For two reasons:

- First, if we focus on relative increments alone, a company could essentially merge to monopoly without interference if the necessary mergers are just sliced into sufficiently many sequential small deals (so that the individual price effect of each single one is also small). That contradicts basic logic. If we are concerned about A merging with B, we should be equally concerned about B selling assets to A in a sequence leading to the same end result. The only way to address this is by having absolute market power standards in addition to relative increment standards.

- Second, when a merging firm is dominant, small rivals may often play only a minor role for static price competition. However, they may nonetheless play a large role for dynamic competition, as many small firms have the ambition to become large(r) in the future. (Indeed, sometimes that's why the dominant firm may be interested in buying it in the first place!) In that sense, we think one should be very careful when dominant firms buy small direct competitors (potential or actual)."

[15] See Valletti and Zenger, op. cit., supra note 2 at 4. (Emphasis added.)

[16] European Commission, Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings (2004/C 31/03), para. 28. (Emphasis added.)

[17] See Valletti and Zenger, op. cit., supra note 2 at section III.A.

increases. Indeed, in a very recent paper, Kwoka shows that cleared mergers involving firms with large market shares were more likely to induce price effects.[18]

In my opinion, however, what that literature shows is that competition authorities, especially in the United States, may have incurred in Type II errors, clearing transactions that should have been prohibited (or conditioned more severely). These studies thus provide support to the so-called "structural presumption" against mergers of firms with large market shares but, to the best of my understanding, that they would not endorse a "margin presumption" against mergers involving one or more high margin firms. It is important to note, in addition, that this literature does not rule out the possibility of Type I errors, i.e. incorrect prohibition or remedy decisions, because it is not possible to observe what would have been the outcomes of mergers that have not taken place.

Finally, Prof Valletti and Dr Zenger seem to consider that a more interventionist merger control policy is needed due to the observed trend in margins in recent decades. This may well be the case but, as noted in section II above, the jury is still out as regards the ultimate causes of that trend. If margins increase because firms innovate to differentiate their products, then attacking mergers between high-margin firms *per se* would erroneous public policy; society would be better served retaining the GUPPI framework we have been using in recent years.

IV. CONCLUSION

My original paper contained three policy propositions. First, there is no justification for the adoption of a policy that targets mergers in high-margin industries. Second, there is no justification for a policy that targets high-margin firms especially. Third, while margins in western economies have increased in recent decades, this does not justify a radical change in merger control policy. Prof Valletti and Dr Zenger agree with the first and third propositions but disagree with the second. In this brief paper I have explained why I believe their arguments against my second proposition do not invalidate it. I would like to thank them for the opportunity to clarify my thoughts.

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[18] J Kwoka, 'The Structural Presumption and the Safe Harbor in Merger Review: False Positives or Unwarranted Concerns", *Antitrust Law Journal*, 2018.