

# REVIEW OF THE CMA'S APPROACH TO VERTICAL MERGERS



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## REVIEW OF THE CMA'S APPROACH TO VERTICAL MERGERS

By Bas Dessens, Vedika Hegde, Dr Nicola Heusel & Alena Kozakova

In a report for the CMA, we reviewed four merger cases that were assessed by the CMA in 2017, which were either purely vertical or had a strong vertical component. We focused on both the quality of the assessment and whether the CMA got to the right result. We also offered some recommendations for further improvement. We revisited our report to see whether there have been any notable changes in the CMA's approach since we made our recommendations. Against that background we performed a high-level review of four further cases that caught our attention over the past two years. We found that some of the same issues are still present in the CMA's decision practice, although significant streamlining appears to have taken place with far fewer theories of harm being investigated and a far clearer focus.

## I. EXECUTIVE SUMMARY

In recent years, vertical mergers have come under increased scrutiny which appears mainly driven by concerns about perceived underenforcement in relation to acquisition strategies of major tech platforms. In a report for the CMA, we reviewed four mergers that were assessed by the CMA in 2017, which were either purely vertical or had a strong vertical component. They comprised, *Tulip/Easey*, *Tesco/Booker*, *Mastercard/Vocalink*, and *Heineken/Punch*. All four cases were cleared.

We focused on both the quality of assessment and whether the CMA got to the right result. We also offered some recommendations for further improvement. By and large, we found high quality analysis and we did not find significant errors. We identified a few points for improvement, that can be put into two categories – the first category relates to the need to consider business evidence carefully, including the wider reality of a sector (such as merger waves). The second category related to the need to ensure that the substantial lessening of competition (“SLC”) test is done consistently and efficiently, including a consistent consideration of entry, consistent application of the ability-incentive-effects foreclosure test, a focus on key theories of harm and flexibility in the approach to new types of harm.

We revisited our report to see whether there have been any notable changes in the CMA's approach since we made our recommendations. Against that background we performed a high-level review of four further cases that caught our attention over the past two years. This review included *Amazon/iRobot*, *Broadcom/VMware*, *Microsoft/Activision*, and *Cérélia/Jus-Rol* – a case that was considered horizontal by the CMA but vertical by the parties.

We found that some of the same issues are still present in the CMA's decision practice, although significant streamlining appears to have taken place with far fewer theories of harm being investigated and a far clearer focus. The cases continue to be complex and require a lot of intellectual agility to get right, both for the authorities and the advisers of the merging parties.

## II. BACKGROUND

In late 2021, the CMA asked us to review four past decisions involving mergers that were either vertical or had a vertical component. The CMA asked three questions: (i) whether it correctly appraised those mergers; (ii) whether it got to the right result; and (iii) what general lessons for the future the CMA can draw from its past practice. In what follows we discuss the cases we reviewed and our observations and the general lessons learned from across those cases.

Vertical mergers have been a battleground for academics, authorities, lawyers, and economists. A vast body of theoretical literature has discussed the pro- and anti-competitive effects of vertical integration which has historically been associated with enhancing efficiency, and was presumed to be either wholly or mostly benign. In particular, vertical integration can lead to the elimination of double marginalization (“EDM”).

Academics have recently begun to question the premise of EDM. It is especially the rise in the importance of digital markets which may have resulted in a sequence of potentially anti-competitive non-horizontal deals by leading platforms, that made the debate around vertical mergers more important.

Foreclosure is the primary concern with vertical mergers. Depending on who is being foreclosed, competition authorities investigate consumer foreclosure (access to distribution) or input foreclosure (access to a key input). The assessment typically relies on a three-step test of ability, incentive, and effects to assess the potential foreclosure strategy. If ability to foreclose is found lacking, there is no need to test for incentives. If there is ability, but incentives to foreclose are not present, there is no need to investigate the potential effects on competition.

Although vertical merger assessment often focuses on foreclosure, other potentially anti-competitive effects may be important, and can lead to the merger being harmful even in the absence of foreclosure, such as the abuse of sensitive information by vertically integrated firms or coordinated effects.

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### III. THE CMA CASES WE REVIEWED

#### A. Tulip/Easey

Tulip, a vertically integrated pig farmer, processor, and supplier of fresh and processed pork, acquired Easey, a pig farming operation specialized in outdoor bred pigs. The parties' activities overlapped vertically as Easey supplied pigs on the merchant market for producers of pork products such as Tulip.

The CMA investigated input foreclosure. It was concerned that post-merger, Tulip would control a substantial proportion of the supply of outdoor bred pigs for slaughter but concluded that downstream rivals would have access to sufficient alternative supplies from entry and expansion. The case was cleared at Phase 1.

We found the CMA assessment to be accurate, although it might have spent a little too long investigating a competitor complaint and been a little optimistic when assessing entry. The main challenge we identified was the effect of the gradual consolidation along the supply chain on independent players who were bringing most innovation into the industry. We found that this effect was hard to capture under the existing tests applied by the CMA.

#### B. Heineken/Punch

Heineken, a global brewer, and owner of the Star pub network in the UK, sought to acquire the Punch pub network. The CMA pursued three vertical theories of harm ("ToH"): i) input foreclosure, ii) customer foreclosure, and iii) a reduction in the range of products offered, in addition to a horizontal concern in the pub segment.

On the input foreclosure front, the CMA investigated the possibility that Heineken could stop supplying rival pubs and/or might offer them worse terms to drive customers to its own pubs. On the customer foreclosure front, the CMA investigated whether Heineken could limit volumes of drinks supplied by other brewers in Punch pubs. In both cases, Heineken's modest market shares led the CMA to conclude that it would have no ability to foreclose. The CMA also investigated whether the merger would be associated with a reduction in choice of beers and cider, especially from small local breweries. It considered that the merged entity would have had the ability to reduce choice, but not the incentive as this would reduce its competitiveness in the pub market. The case was cleared in Phase 1 subject to a divestment to remedy local horizontal concerns.

While we did not disagree with the clearance decision, we thought the appraisal could have been streamlined. For instance, input and customer foreclosure were unlikely to occur at the same time. All the complaints received (a substantial number) were about customer foreclosure which was clearly the dominant theory. We also thought that splitting customer foreclosure into two separate theories of harm (effect on competitors and effect on customers through range reduction), made the concerns harder to investigate.

#### C. Tesco/Booker

In 2017, UK's largest groceries retailer, Tesco, acquired UK's largest groceries wholesaler, Booker. The merger was mainly vertical, with some horizontal overlaps at the retail level. The CMA investigated different types of vertical concerns (a standard input foreclosure, a "wholesale to retail" theory of harm, and a less standard concern related to horizontal harm with a vertical recoupment mechanism, "retail to wholesale" theory of harm) in addition to a horizontal concern at the retail level. The case was subject to a fast-track to Phase 2 and then cleared unconditionally.

We agreed with the CMA clearance decision and noted the high quality of the analysis. We thought, however, that the CMA could have streamlined the decision and cleared the case already at Phase 1, had it pushed harder to conclude on the ability to foreclose. We also cautioned against the complexities of vGUPPIs<sup>2</sup>, which may lead to spuriously accurate results, and against the proliferation of theories of harm.

Finally, we considered that the CMA identified a theoretically correct concern related to horizontal harm with a vertical recoupment mechanism (the "retail to wholesale" theory of harm). This, however, is not a standard input foreclosure theory and does not appear to be covered in the CMA's existing Merger Assessment Guidelines. We recommended the CMA clarify its approach to such concerns for future mergers, as they are likely to reoccur.

<sup>2</sup> Vertical Gross Upward Pricing Pressure Index which measures the incentive of the merging parties to increase prices or otherwise worsen their offer following a vertical merger.

#### D. Mastercard/Vocalink

Mastercard provides credit and debit card payment schemes. It also operates a network of ATMs and provides infrastructure for them. Vocalink provides infrastructure services to the UK largest ATM network, LINK, and for UK interbank payments. It also developed a real-time payment technology that allows the payee to pay a merchant directly online.

The CMA investigated a mixture of vertical and horizontal concerns, and actual and potential competition concerns. It focused on the ATM/cash industry (input foreclosure and upstream horizontal concern), on the interbank payment industry (upstream horizontal concern), and on potential (horizontal) competition concern in the card payment industry. The CMA found no concerns regarding the vertical and potential competition theories of harm, but identified a horizontal concern in the ATM industry where it required a partial divestment of Vocalink to LINK. The case was cleared subject to this remedy at Phase 1.

We considered this case to be highly complex – hard for the CMA to assess and for us to review. We did not necessarily disagree with the CMA's clearance decision, but found a number of issues that required, in our view, a pause for reflection. In particular, we found that the ATM industry finding of no vertical SLC, but a horizontal SLC, was internally inconsistent as both theories relied on the same evidence and referred to substantially the same business issue. We considered that the choice of lens (horizontal v. vertical) made the difference in the CMA's conclusions.

We also thought that the concerns in the interbank and card payments could have been streamlined into one issue of input foreclosure within the interbank payments (infrastructure level) to protect the Mastercard card business from potential competition from interbank payments (customer level). This would have been a more complex theory of harm involving diagonal harm and potential competition, but in our view a more accurate one than the three more standard theories of harm that the CMA investigated instead. We thought that the CMA's Merger Assessment Guidelines were not adapted to guide the CMA assessment in such complex cases. This may have led the CMA to investigate a larger number of theories of harm, each of which focused on one relevant aspect of the case using well-established theories, but none of them fully encompassing the complex business reality of the case. Given that many of the digital deals that the CMA is currently facing involve issues related to such non-standard, non-horizontal potential competition harm, we recommended that the CMA clarifies its thinking on this issue.

### IV. OUR RECOMMENDATIONS TO THE CMA

Our review indicated that the CMA generally undertook high quality and thoughtful analysis. We did not conclude that the CMA made manifest errors of judgement or reached the wrong conclusion. We identified a small number of areas where it could improve on how it investigates cases. In particular, we thought the CMA could consider business evidence a little more carefully and improve the consistency of its SLC testing.

#### A. The Need for Deeper Consideration of Business Realities

##### 1. Rationale for the merger and business evidence

Non-horizontal mergers are harder to grasp from a competition perspective. We thought the CMA could have focused more on understanding the parties' rationale for the deal. In two cases, *Tulip/Easey* and *Tesco/Booker*, the parties ended up doing exactly what they told to the CMA that they were going to do. In the case of *Heineken/Punch*, there was plenty of evidence hinting to what Heineken was going to do in internal documents and in submissions from third parties. *Mastercard/Vocalink* was harder to grasp.

We understand that competition authorities are weary of rationales written for the purpose of antitrust filings, but we found that they were still useful reading and that there was other evidence that could have corroborated the parties' story. We found that in three out of the four mergers, there was an understanding within the industry about what the merger was going to achieve, which was then borne out by reality.

Similarly, we thought that the consideration of business evidence could be very important in non-horizontal mergers cases. In all four cases, the CMA could have derived useful knowledge from it. We felt that this evidence was somewhat underused and in one case inappropriately overridden by considerations related to economic theory.

## 2. Gradual Solidification of the Supply Chain

In all four case studies, we have observed a gradual solidification of the industry supply chain. Such a solidification of the supply chain can be efficiency enhancing. We found that the CMA did not appear to take account of any transaction other than the one that it was considering, including past transactions and parallel transactions. We appreciate that this is hard and the legal test may not be adapted to allow the CMA to do so. However, we thought considering a more “dynamic counterfactual” could have helped in all four cases, at least as far as the economic analysis was concerned.

### **B. Consistency of SLC Testing**

#### 1. Homing in on the Most Pertinent Theory of Harm

We found the CMA investigations to be very thorough. This thoroughness meant that some theories were carried forward for much longer than we thought was necessary. For instance, the *Tesco/Booker* case could have, in our view, been cleared much earlier had the CMA concluded its assessment of the first step of the ability, incentive and effects test – ability to foreclose.

Similarly, several theories of harm can “nibble” at the main issue from different angles but may miss the main picture. We appreciated that it was difficult to resist as the CMA did not want to miss a key angle to the case or an important nuance but recommended greater boldness in narrowing the story down to a leading narrative.

#### 2. Using the Existing Tests Consistently

We found that the CMA generally followed its guidance thoroughly. However, we thought that its approach to assessing evidence of entry still appeared to be somewhat case dependent, with rigor applied in some cases (*e.g. Mastercard/Vocalink*) and more optimism in others (*e.g. Tulip/Easey*).

Most strikingly, *Mastercard/Vocalink* showed that the choice of lens might mean a different outcome to the case with a vertical lens appearing to involve higher burden of proof than the horizontal lens even when the same business facts were being considered.

#### 3. Updating the Vertical Toolkit

Non-horizontal and platform mergers bring issues that are sometimes hard to classify and require continued work on the assessment toolkit of the regulator. We came across two such issues: i) a horizontal concern with a vertical recoupment mechanism (*Tesco/Booker*) and ii) potential competition concern in a diagonal setting (*Mastercard/Vocalink*). These issues are not easily assessed using the existing Merger Assessment Guidelines of the CMA. We recommended an update.

We also recommended careful consideration of the application of the vGUPPI test. We thought that this test was very intuitive in theory, but in practice, quite hard to apply, harder than its horizontal cousin, the GUPPI, requiring far more assumptions that may be hard to justify. We recommended caution when using the vGUPPI test.

## **V. CMA CASES SINCE OUR REVIEW**

We sampled the CMA’s enforcement practice since our review. Of the many vertical cases that the CMA reviewed since, there are three we thought worth discussing: *Amazon/iRobot* (2023), *Broadcom/VMware* (2023), and *Microsoft/Activision* (2023). We also reviewed *Cérélia/Jus-Rol* (2023). This last merger was, ostensibly, not considered as a vertical merger by the CMA, but we considered that the key issue at hand was vertical. The CMA cleared *Amazon/iRobot* in Phase 1 and *Broadcom/VMware* in Phase 2. The CMA initially prohibited both *Microsoft/Activision* and *Cérélia/Jus-Rol*. Both decisions were appealed. The *Cérélia/Jus-Rol* decision was upheld. The CMA agreed to reconsider the *Microsoft/Activision* deal following a refiling which addressed the CMA’s concern. The restructured case was ultimately cleared.

We did not consider perhaps the most iconic case of the past couple of years, *Facebook/Giphy* (2023), since the case was well under way when we started our initial review.<sup>3</sup>

<sup>3</sup> This CMA investigated the case on both vertical (input foreclosure) and horizontal grounds (potential competition) grounds and prohibited on both. The parties appealed the case focusing on the horizontal ground. The CAT upheld the decision on all substantive grounds appearing to lay out its own thinking on dynamic competition.

### **A. Amazon/iRobot**

Amazon, an online retail company also manufacturing electronic devices, including devices for use at home such as smart home platforms, acquired iRobot, a manufacturer of robot vacuum cleaners. The CMA considered one horizontal theory of harm with respect to potential competition (manufacturing of robot vacuum cleaners) and two vertical theories of harm – input foreclosure and customer foreclosure.

The input foreclosure theory was related to the possibility for Amazon to limit supplies of iRobot products to other distributor platforms. The customer foreclosure theory was related to Amazon potentially limiting access to its distribution platform for other manufacturers of robot vacuum cleaners. The latter theory was the dominant one, as Amazon’s power as a distribution platform has recently been receiving notable regulatory interest. This theory also led to the European Commission opening its own in-depth investigation into the transaction.

We considered that this case had parallels with *Heineken/Punch* whereby one theory of harm – a customer foreclosure – seemed to be the dominant narrative in the industry, subject to previous and ongoing regulatory scrutiny, while the other theory of harm – input foreclosure – did not appear to be a live concern. Both theories also generally required quite different market conditions. It appears to us that the need to investigate every nook and cranny, rather than focus resources on the key concern might still be an issue the CMA is sometimes wrestling with.

### **B. Broadcom/VMware**

Broadcom supplies hardware components for servers and VMware supplies virtualization software that is primarily used either in data centers or in cloud services. Server virtualization software enables the processing power of a single server to be segmented into a number of ‘virtual machines’.

The CMA focused mainly on input foreclosure investigating whether Broadcom (a hardware manufacturer) was likely to continue to supply VMware software to other hardware manufacturers given that this software was a key input. The CMA also investigated whether Broadcom would have access to commercially sensitive information about competing hardware manufacturers thereby reducing its incentive to innovate in the hardware market.

We considered that this case brought to light the importance of considering the vertical link to understanding competitive interaction within a horizontal setting. In *Tesco/Booker*, the concern was that any loss of competitive effort downstream might be recouped through a newly acquired business link upstream. In this case, the supply of a key component upstream might allow Broadcom to gather key information about competitors which would allow it to tailor competitive behavior downstream. For us, this would highlight the importance of proper guidance on this particular type of vertical concern which is not a simple foreclosure theory of harm, but, as the *Tesco/Booker* and *Broadcom/VMware* cases show, it is not a rare one.

### **C. Cérelia/Jus-Rol**

Cérelia is UK’s largest manufacturer of dough-to-bake products. Jus-Rol is the UK’s largest supplier of branded dough-to-bake products to grocery retailers in the UK. The CMA considered one horizontal theory of harm – reduction of competition in the wholesale supply of dough-to-bake.

The parties strongly objected to CMA’s classification suggesting that the deal was purely vertical: Cérelia is a manufacturer of dough-to-bake for grocery retailers who own private label brands under which these products are manufactured. Jus-Rol is a brand, not a manufacturer. Cérelia manufactures most of Jus-Rol products. The parties suggested that the CMA should instead investigate input foreclosure.

The CMA reasoning (upheld on appeal in its entirety) was that “*the existence of a vertical relationship of this nature does not preclude that the Parties compete horizontally*” (para 8.4 of the Final Report). We find this statement and the general approach interesting: indeed, in all cases of problematic vertical mergers, competition will in the end be lessened within a particular horizontal setting. In our view, it does not mean that we would be wise to do away with a vertical foreclosure theory of harm. This issue is even more pronounced in cases with a vertical recoupment mechanism for a horizontal lessening of competition. That type of concern is likely a hybrid of a vertical and horizontal theory of harm that will not fit satisfactorily in a single box, nor should it be made to.

Given that Jus-Rol was not involved in any manufacturing, we consider that the Parties had presented a reasonable challenge to the CMA. Whether the case should have been cleared is a different matter – Cérelia was the largest manufacturer of dough-to-bake products and Jus-Rol the largest brand. The CMA was not convinced that entry into manufacturing was particularly likely or timely.

#### D. Microsoft/Activision

Microsoft is a key player in the gaming industry, both on consoles and cloud platforms. Activision Blizzard is a major game developer with a hugely popular Call of Duty game. The CMA investigated two vertical theories of harm: i) input foreclosure in the console gaming market and ii) input foreclosure in the cloud gaming market.

*Microsoft/Activision* was one of the key deals of 2022/23 with multiple jurisdictions reviewing the transaction and a large amount of interest. The CMA satisfied itself that input foreclosure was unlikely to be profitable in the console gaming market but found that it was likely to take place in the cloud gaming market. It rejected the parties' behavioral remedy (unlike the European Commission, which accepted it). The case was appealed and recently a modified version of the deal was refiled to the CMA with cloud gaming being divested, outside the EEA, to Ubisoft. The CMA has accepted this restructured deal.

This was a rather standard input foreclosure case which did not involve concerns regarding potential competition in a non-horizontal setting that tend to feature in many platform cases involving major digital platforms. It was also a streamlined case with one theory of harm per market segment.

We considered the treatment of the first theory of harm (input foreclosure in the console gaming market) interesting from our perspective: the CMA concluded that Microsoft would have neither the ability nor the incentive to foreclose rivals. In theory, the CMA should have felt comfortable to stop the investigation after it found no ability to foreclose. In practice, the ability test appeared to have elements of an incentive assessment and vice versa. We found this analytical approach also present in the four mergers we assessed. We would have preferred a closer adherence to the consecutive ability-incentive-effect test as it can, in many cases (*e.g. Tesco/Booker*), lead to far greater clarity far earlier. However, we suspect that the bulk of the incentive analysis was unavoidable, since the ability test was likely to be met.

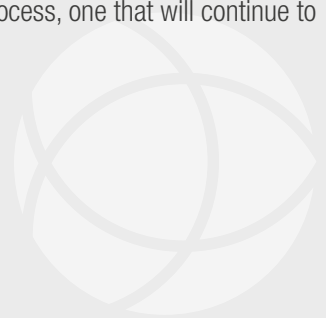
The foreclosure finding in the cloud gaming segment is the one that generated the headlines. From our narrow perspective, we note that the CMA does appear to be increasingly explicit about the dynamic effects of foreclosure in markets where it anticipates change in the future and is now comfortable using a single theory of harm to investigate it.

## VI. CONCLUSION

Vertical mergers, and non-horizontal mergers in general, are hard to assess. The dust has not settled on the debate regarding their potential for anticompetitive effects. Such cases are invariably more complex and require a deeper understanding of the industry. The ability-incentive-effects test to assess the main concerns also appears hard to implement in practice. No wonder that there is a sense of under-enforcement and that competition authorities have been historically accused of putting vertical concerns into horizontal boxes to limit this risk.

In our review we have found that despite these complexities, the CMA was doing, by and large, good work when it comes to assessing vertical mergers. We identified some risk factors for future cases and room for further improvement. We pointed out, in particular, that theories of harm in non-horizontal settings required fine tuning, that it was important to focus on the key theories and that the SLC testing required careful calibration.

Looking at recent cases – and without the in-depth assessment we carried out on the original four cases – we find that some of the risk factors still appear to be present. We do note, however, that the CMA seems to be moving to bolder and simpler theories of harm rather than “nibbling away” at a case in a variety of (in our view less efficient) ways, as it tended to do in some past cases. We still see a temptation to consider cases that have an important vertical element as horizontal and conflation of the different steps in the ability, incentive and effects assessment. We see the CMA tackling some of the less straightforward theories of harm where horizontal and vertical theories meet, though it could do so with a clearer “plan”. Vertical mergers are and will remain a fascinating part of the merger review process, one that will continue to require a lot of hard thinking.



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