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Do efficiencies ever deliver? Lessons from the UPS/TNT case

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Case is notable for two reasons:

- It represents one of the few ‘gap’ cases since the adoption of the new merger test and some commentators have suggested that it signals a trend towards a more interventionist approach by the Commission

- It raises, once more, questions on the extent to which parties should rely on efficiencies in their defence

Overview

- Price discrimination and market definition
- Empirical analysis of unilateral effects: Price concentration analysis
- Efficiencies to the rescue?
- What role for efficiencies going forward?
- Conclusions

Price discrimination and market definition (I)

- Parties argued that for many customers express services and deferred services offered by ground-based operators are substitutable

- However, the Commission pointed out that the mere existence of such “marginal” customers does not imply that prices would be kept down for all customers

- Widespread application of price discrimination played a key role in this context

Price discrimination and market definition (II) – An example

- Suppose that only half of A's customers consider B as an effective substitute

INFRA-MARGINAL CUSTOMERS	**MARGINAL CUSTOMERS**
Customers for whom B is NOT a substitute	Customers who would switch to B if pA > €10

- If A is unable to price discriminate, it finds it optimal to charge a price equal to €10 to ALL customers
  - Customers for whom B is not a substitute are protected by "marginal" customers
- If price discrimination is possible, A will charge a high price to "infra-marginal" customers (e.g. €12) and a price equal to €10 to "marginal" customers
  - "Marginal" customers do not offer any protection to "infra-marginal" customers

Price discrimination and market definition (III)

- Commission's press release:
  - *"Most customers negotiate discounts, which can be substantial. In this context, service providers collect detailed information on customers, notably on their expected and past shipping behaviour, volumes and specific requirements for delivery speed. This allows service providers to identify customers that would be unlikely to consider deferred services as an option and would therefore more easily accept a price rise for express services"*

- Existence of customers that would be willing to substitute express and deferred services would not offer any protection to those that are unable or unwilling to switch since
  - prices are individually negotiated
  - suppliers have a good knowledge of their customers' needs

- As a result, the Commission defined a separate market for express services

Empirical analysis of unilateral effects: Price concentration analysis (I)

- Price discrimination also implied that although some EU customers see FedEx as an effective substitute, in many countries the transaction was effectively a 3-to-2
  - Commission feared the merger might result in a significant loss of competition

- Empirical support for the Commission's concerns was provided by a price concentration analysis submitted by the merging parties themselves

- **Key question: does UPS charge a lower price where it faces a larger number of rivals?**

Empirical analysis of unilateral effects: Price concentration analysis (II)

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- Example: pA = €20 - €3*DB + €0.1*DC - €0.2*DD

  where:

  DB=0 if B is not present and DB=1 if B is present

  DC=0 if C is not present and DC=1 if C is present

  DD=0 if D is not present and DD=1 if D is present

- If coefficient associated with DB is statistically significant, then merger between A and B may be expected to give rise to a price increase

- The results of the parties' economists' analysis are summarized in the Commission's press release
  - *"[a significant loss of competition] has been corroborated by the price concentration analysis conducted by UPS. ...This analysis predicted that prices would increase in 29 EEA countries, despite DHL's position as market leader in a number of countries"*
  - *"The Commission performed its own price concentration analysis, which confirmed this outcome but forecasted higher price increases than UPS' model"*

Efficiencies to the rescue? (I)

- Profit-maximising firms will often wish to pass on some portion of any cost reduction to customers via lower prices

- In particular, if a merger leads to a reduction in the merged firm's marginal costs, this will create a clear incentive to reduce prices that may partly or entirely offset any incentive to raise price

- As a result, efficiencies can neutralise or outweigh the adverse effects of a merger

Efficiencies to the rescue? (II)

Three conditions must be satisfied:

- Efficiencies must be merger-specific
  - Commission accepted that at least some of the efficiencies were unlikely to be achievable other than by the proposed transaction
- Consumers must benefit from the efficiencies
  - Commission concluded that the savings that UPS would make with respect to ground and air transportation would be likely to benefit consumers. However, it found that the overhead costs savings would be unlikely to be passed on
- Efficiencies must be sufficiently certain and substantial
  - Cost savings from ground transportation were dismissed because it was not sufficiently clear that these savings would accrue specifically to express deliveries

Efficiencies to the rescue? (III)

- Only efficiency arguments with respect to air transportation were ultimately accepted

- After calculating the part of these cost savings that would be likely to be passed on to consumers, the Commission found that these efficiencies would not outweigh the price increases caused by the lessening of competition, as predicted by the price concentration analysis

- Commission therefore concluded that the transaction would be likely to give rise to anticompetitive effects in 15 European countries

What role for efficiencies going forward? (I)

- *UPS/TNT* further confirms that merging parties face extremely tough hurdles when putting forward an efficiency defence

- Not a revelation if one considers that although the Commission has accepted certain efficiencies in some recent cases, efficiency defences have never been sufficient to overturn a finding of adverse effects on competition

- Commission can in general be criticised for taking an overly sceptical and narrow view of efficiencies
    - For example, the distinction between cost savings that will affect pricing and those that will not is far more complex than a simple split between fixed and variable costs

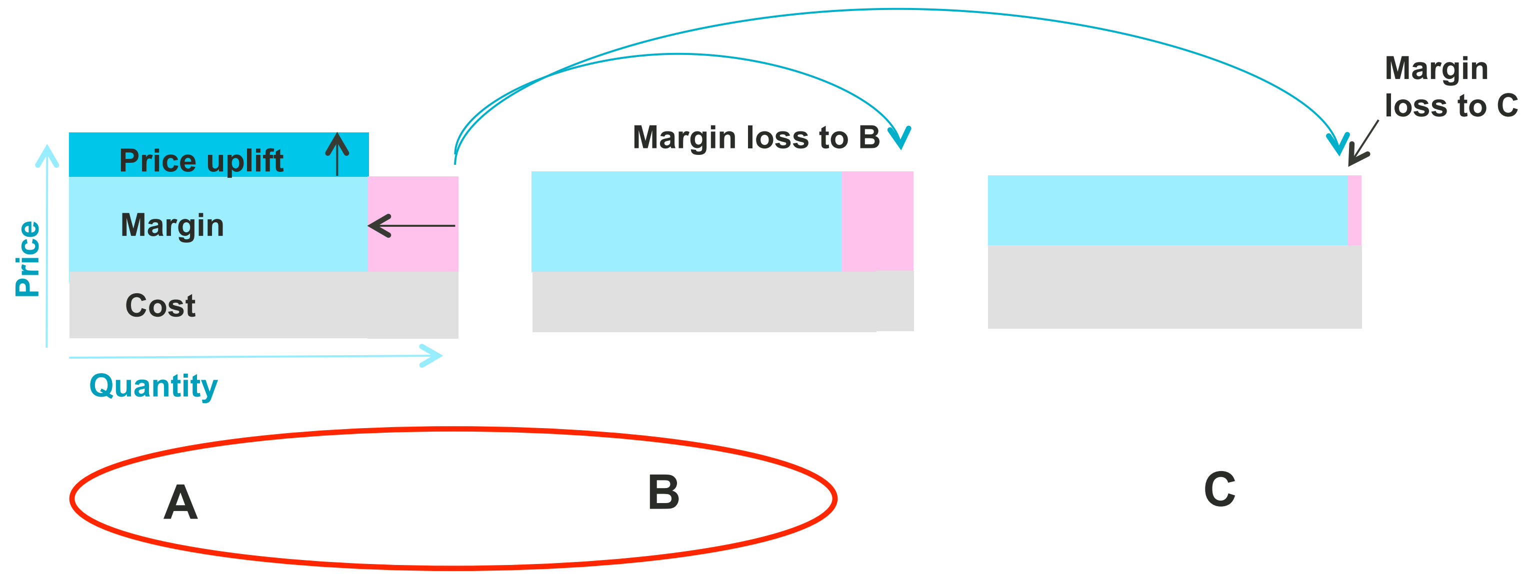
What role for efficiencies going forward? (II)

- Economists must also bear some of the responsibility for placing too much weight on efficiencies
- One root of this problem is the increasing and often uncritical reliance on simplistic theoretical models of unilateral effects, such as the UPP test

$$\textbf{UPP} = \textbf{Margin (B)} \times \textbf{Diversion ratio} (\textbf{A} \rightarrow \textbf{B}) - \textbf{Efficiencies (A)} \times \textbf{cost (A)}$$

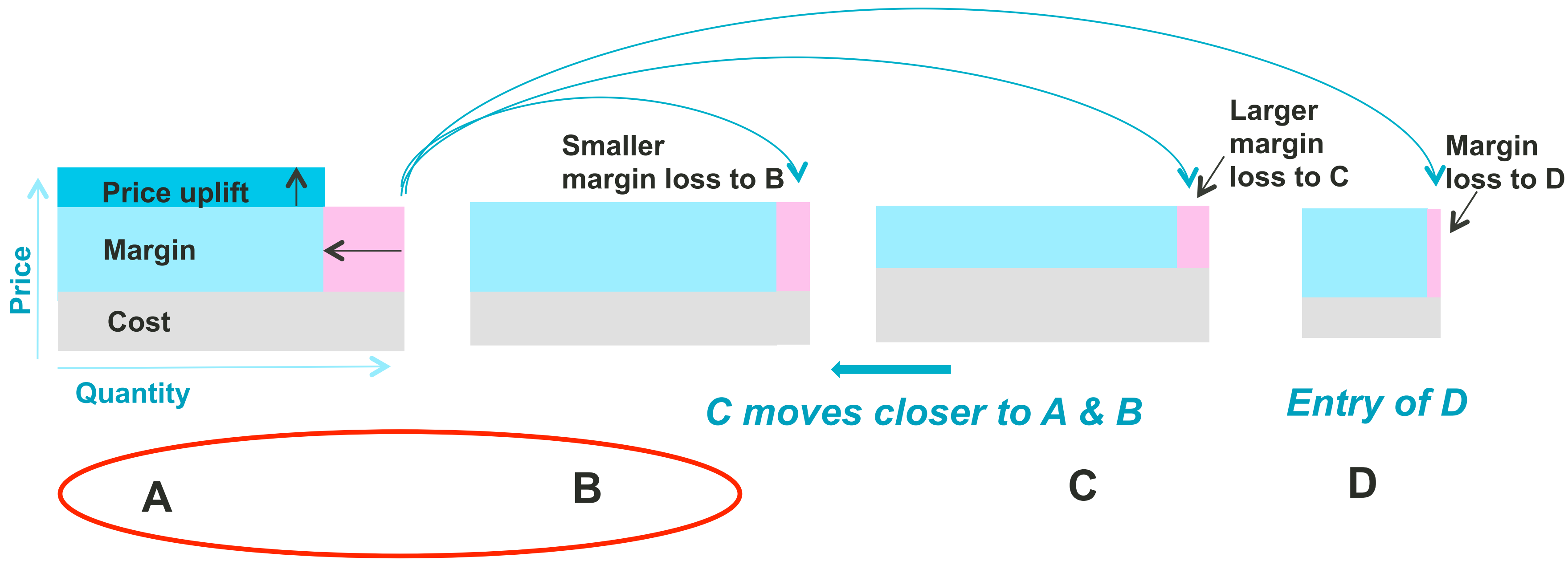
- These models have many drawbacks:
  - They are only an apparently more sophisticated alternative to simple reliance on market shares
  - They have come to be relied upon to the point at which they imply a deterministic link between industry structure and competitive outcomes
  - Efficiencies are the only antidote to the harmful price effects that are predicted to arise in every horizontal merger
  - Other potentially more relevant lines of analysis are completely neglected (see next slide)

What role for efficiencies going forward? (III)



- Pre-merger, price uplift < margin loss → hence no price increase
- Effect of the merger is that A internalises losses to B, making price increase profitable

What role for efficiencies going forward? (IV)



- If price of A rises, C may produce a good closer to A (to win more customers from A) and/or D may enter
- This reduces A's incentive to increase price
- Pre-merger diversion ratios may not be a good estimate of post-merger diversion

Conclusions

- A review of the assessment in *UPS/TNT* does not convincingly establish that this case marks a significant tightening of mergers policy as some commentators have suggested

- Although the Commission did make an effort to incorporate efficiencies into the assessment, the efficiency defence ultimately failed [again]

- As such, it remains questionable whether efficiencies will ever play an important role in any but the most exceptional cases