Removal of Potential Competitors – A Blind Spot of Merger Policy?

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Abstract
In dynamic industries, firms often face new competitive threats. If firms are able to identify those threats early on, they may simply acquire potential competitors under the radar of competition authorities. Merger policy thus has to deal with two issues: (1) how to make sure that potentially problematic mergers are notified and investigated; and (2) how to assess the social costs and benefits of such mergers. The latter requires to take a stance regarding the standard and burden of proof. We argue for a reversal of burden of proof, at least if one of the merging firms is considered to be a “systemic firm”.

Keywords: Merger policy, potential competitor, notification, standard of proof, burden of proof, killer acquisition

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1. Introduction

In this article, we raise a number of concerns in merger control regarding mergers that may look conglomerate or vertical at first glance, but, in essence, are horizontal, as they constitute the removal of a potential competitor.\(^2\) Our take on merger control is that there is under-enforcement. In particular, when dealing with the removal of potential competition, merger regulation should make sure that the antitrust authority (AA) is informed about all relevant mergers and be in a position to prohibit mergers that are expected to do more harm than good.\(^3\)

Many conglomerate and vertical mergers can be addressed from the perspective of potential competition. For example, if two firms operate in different geographical markets, a merger often allows for better access of products from one firm to the geographic market in which it was not active before. If absent the merger the acquirer was going to enter that market in any case, the merger constitutes a removal of a potential competitor. The same holds in reverse: if the target was going to enter the acquirer’s market absent the merger, then the acquirer removes a potential competitor in its home market through the merger. The argument not only applies to different geographic markets, but more broadly to product markets related on the supply or demand side including different layers in the supply chain.

Economists have started looking into pharma and digital to uncover cases of the removal of potential competitors — more on this later. However, the issue is not restricted to these sectors. For example, it has been claimed that Covidien, a large medical device manufacturer, acquired Newport to remove a competitive threat in the market for ventilators.\(^4\)

In this article, first, we refer to some well-established theory and recent empirical evidence on the removal of potential competitors. Second, we address the issue of notification thresholds in merger control, which are of particular relevance in some mergers related to the removal of potential competitors. Third, we discuss standard and burden of proof when assessing the impact of a merger involving a potential competitor.

\(^2\) Conglomerate and vertical mergers are not the focus of this paper, among other things because the effects of vertical mergers, traditionally seen as benign, are still the object of research and debate.

\(^3\) In this article, we draw on Massimo Motta and Martin Peitz (2019), “Challenges for EU Merger Control”, Concurrences 2019(2), 44-49, and Massimo Motta and Martin Peitz (2020), “Big Tech Mergers”, Information Economics and Policy, forthcoming. Here we provide a more-complete and more-nuanced view compared to the ones expressed in our earlier work. However, some parts of this article are taken verbatim without quotation marks from our earlier pieces. For a complementary exposition, see OECD, “Start-ups, Killer Acquisitions and Merger Control – Background Note”, May 12, 2020.

\(^4\) As the New York Time reports, “Government officials and executives at rival ventilator companies said they suspected that Covidien had acquired Newport to prevent it from building a cheaper product that would undermine Covidien’s profits from its existing ventilator business.” (Nicholas Kulish, Sarah Kliff, and Jessica Silver-Greenberg, “The U.S. Tried to Build a New Fleet of Ventilators. The Mission Failed”, New York Times, March 29, 2020)
2. Well-established theory and recent empirical evidence on the removal of potential competitors

Examples of mergers that may remove potential competitors come from (but are not limited to) the pharma and the digital sector. In recent years, Amazon, Apple, Facebook, Google, and Microsoft have been taking over dozens of small technology firms which have not marketed their products yet or were at an initial phase of roll-out. When one of these giants takes over a small start-up with a very promising technology, which may develop into a substitutable product/technology, there may be a possible pro-competitive effect from this transaction: it is possible that, say, Google may further develop the search technology of a start-up, using its financial, technological and marketing clout, and incorporate it into its own search engine, whereas the start-up may have never been able to hit the market. However, the start-up may have been viable by itself or together with a different firm that is less entrenched than Google. It is also possible that the start-up may have further developed the technology and become a competitive threat to Google. Note that the pro-competitive effect (a marginal improvement in Google search engine) would likely be quite small when compared with the expected gain if the new technology had grown to challenge Google search (that, however, is a low probability event, but one with a huge benefit for the market). Specific to digital markets, a report commissioned by the UK Competition and Markets Authority (CMA) contains a critical ex-post evaluation of recent UK merger cases. In some of these cases the removal of a potential competitor figures prominently.5

At the extreme, after the takeover the acquiring firm may simply decide not to develop the technology at all, resulting in a “killer acquisition”, namely an acquisition motivated by the objective to extinguish a technology which would otherwise create future competition and dissipate industry profits. Colleen Cunningham et al. have gathered empirical evidence that documents the widespread existence of “killer acquisitions” in the pharmaceutical industry.6 By looking at the evolution of project development of thousands of drugs (their data cover about 25 years), they show that acquired drug projects are significantly more likely to be discontinued than those which have not been acquired. Likewise, a drug is significantly less likely to be continued in the development process in each year if it has been acquired.

Cristina Caffarra et al. have argued that “reverse killer acquisitions” can be observed in big tech.7 Big tech platforms include new functionalities and services by acquiring startups, but they discontinue or forego their own efforts in developing rival innovations. While the benefit for users of such integrated offers

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6 See Colleen Cunningham, Florian Ederer, and Song Ma (2018), “Killer Acquisitions”, Yale School of Management WP.
could be directly experienced, the potential competitive harm has been overlooked.

If empirical evidence is only sketchy and suggestive, from the theoretical standpoint the effects of horizontal mergers on prices are well understood and not controversial: absent efficiency gains the merger between two firms lead them to “internalise” the harm that aggressive pricing imposes on each other, and hence gives them an incentive to increase prices. This in turn pushes competitors, whose residual demand increases, to also raise prices (although typically by a lower percentage). Since all prices increase, the merger will harm consumers. Finally, absent efficiency gains, a merger is also likely to affect negatively investment and innovation, by the same mechanism which leads to price increases: the merging parties will “internalise” the harm that aggressive investment imposes on each other and, hence, gives them an incentive to reduce it.

It is only if the merger entailed large enough efficiency gains that merging parties’ prices may decrease after the merger, in turn leading to lower prices for outsiders and ultimately benefit consumers. Note, however, that the higher the market power held by the insiders the bigger must be the cost savings needed to outweigh the price effect. These insights apply to the acquisition of potential competitors, taking entry by the potential competitor as the counterfactual if the merger is not consummated.

There are of course several considerations which may affect the magnitude of the upward pricing pressure created by the merger compared to the counterfactual in which the potential competitor enters. These include the degree of concentration of the industry, lack of countervailing power of buyers, and the importance of barriers to entry. Apart from price effects, in many industries weaker incentives to cater to the tastes of consumers may be the result of the removal of a competitive threat (e.g., depending on the specific market, lower service quality, more-intrusive gathering of personal data, higher advertising nuisance). If successful competitors broaden the scope of their activity, a forward-looking

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8 If firms primarily compete through capacities or quantities, absent efficiency gains, the merger between two firms lead them to “internalise” the harm that large installed capacity imposes on each other and, hence, gives them an incentive to cut capacity, which is anti-competitive. As a countervailing effect, competitors expand their capacity. However, this does not fully compensate for the lower capacity of the merged firms.


10 Similarly, only large enough efficiency gains entail the merging partners to expand their production after the merger.

11 If insiders have a tiny market share, their merger will likely affect prices only marginally, and consequently very small efficiency gains would neutralise the anti-competitive impact of the transaction; at the other extreme, a merger to monopoly would have a strong impact on prices; hence, very large efficiency gains would be needed to make the merger competitive-neutral.

12 Antitrust authorities may be too optimistic about entry being able to discipline incumbents after a merger. Often, imports or entry that should have prevented price increases do not materialize. For examples, see the report commissioned by the UK Competition and Markets Authority, “Entry and expansion in UK merger cases. An ex-post evaluation”, KPMG LLP, April 2017 (available at: https://www.gov.uk/government/publications/evaluation-of-entry-and-expansion-in-uk-merger-cases).
merger policy accounts not only for the effects on markets under immediate threat of entry, but recognizes that such entry may be the stepping stone to enter other markets in the future in which the acquirer is active or is planning to enter.

Elsewhere we developed a simple economic framework to address the possible anti- and pro-competitive effects of the acquisition of potential competitor. A start-up can develop a project that succeeds with some probability. Whenever the start-up has the ability to pursue its project, the merger will be anti-competitive. The acquisition then becomes either a "killer acquisition" or an upgrade with suppressed competition. The merger can only be pro-competitive if the start-up would not be able to pursue its project absent the merger and if the incumbent will have an incentive to develop the project after acquiring the start-up. The acquisition may also have beneficial ex ante innovation effects: a merger may increase the expected benefit from innovation, and hence stimulate effort to obtain it. Note, however, if the start-up was taken over by another company rather than the dominant incumbent, this benefit would still exist (although to a lesser extent if the takeover price was lower).

In recent work, Michael Katz explores the economic effects of mergers in dynamic markets that feature "competition for the market". This means that the firm offering the larger net gains from trade will eventually make all the sales. A simple way to think about this is that loyal consumers hang around the incumbent firm for a while (to be precise, they are hooked up on the incumbent’s product for some time), while flexible consumers go for the better offer. Clearly, in markets with this feature, a potential entrant must be confident that they will make the better offer to have an incentive to enter. It will first attract the flexible consumers outcompeting the incumbent, while the incumbents stays on for a while as long as it can profitably sell to the loyals. Eventually, the incumbent leaves the market and the former entrant becomes the new incumbent, which will enjoy monopoly profits as long as no other firm enters. When the innovation process is exogenous, a merger between the incumbent and the firm that is about to enter leads to less competition, which is harmful to consumers and society. Then in contrast to markets featuring “competition in the market", the removal of the potential competitor is clearly anti-competitive and does not lead to a reallocation of trade to the more-efficient firm. This tells us that merger policy should be stricter when there is competition for the market.

These theoretical considerations about the anti-competitive effects of mergers involving potential competitors rely on the ability of incumbent firms to identify

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14 The acquisition price may not be the only variable relevant for a start-up to sell out. Whether the payment is in cash or in shares may matter. In addition, there may be non-monetary aspects of the deal. For instance, if the owners stay on as managers, their role in the merged company may be relevant for their decision which offer to accept.

which firms actually are potential competitor. This is arguably easy in the pharma 
industry. Luis Cabral claims that this is not the case in digital industries. As he 
colourfully puts it, “If pharma is like war, digital is like terrorism: You rarely know 
where the next attack will come from. You don’t even know who your enemy really 
is, let alone where it’s located.”\(^{16}\) While it is correct that in digital industries there 
is often no obvious product metric and e.g. certain apps can quickly become 
popular, it is also no secret that at least some established digital players have a lot 
of data and data analytics capabilities to sniff around and detect potential 
competitors.\(^{17}\) This also suggests that there is asymmetric information between 
acquirer and competition authorities, with the acquirer being able to hide the true 
motivation for acquisitions.\(^{18}\)

### 3. Notification

To avoid the AA and businesses being over-burdened with notifying mergers that 
do not raise competition concerns, a *safe harbour* approach has been adopted in 
many jurisdictions. We agree with the following version of such an approach: if 
both parties are small enough in terms of sales and assets, their merger is unlikely 
to raise prices by a significant amount (and even small efficiency gains may render 
it competitive-neutral). It would make sense, then, to allow such a merger without 
scrutiny in order to save resources of both the firms involved (which would 
otherwise have to prove efficiency gains) and of the AAs (which would have to 
check them).

An approach whereby the safe harbour is based on small market overlaps – and 
whereby for instance a leading firm could take over a small one because the latter 
would not add much to the former market share – is not desirable because, absent 
the merger, the insiders might well compete with each other more fiercely than 
indicated by current market positions. In what follows, we consider examples of 
cases where a merger may be anti-competitive despite current market shares 
overlap being absent or minimal. This suggests that on top of structural 
presumptions based on market shares, additional concerns may need to be 
addressed.

forthcoming.

\(^{17}\) For instance, Facebook acquired Onavo in 2012 to operate as its bloodhound. Prior to 
Facebook’s acquisition of WhatsApp, “For months, the company had been tracking WhatsApp 
obsessively using Onavo, a VPN and data analytics app, whose data showed that the messaging app 
was not just a rising competitor, but a potential Facebook killer. The ‘highly confidential’ charts — 
part of a trove of documents released today by the United Kingdom’s digital, culture, media, and 
sport (DCMS) parliamentary committee — show WhatsApp was a growing juggernaut in the 
messaging app wars of the early 2010s.” (Charlie Marzel and Ryan, “These Confidential Charts 
Show Why Facebook Bought WhatsApp”, BuzzFeed, 5 December 2018)

\(^{18}\) Prior to buying Instagram, Facebook CEO Marc Zuckerberg allegedly wrote in an internal email: 
“One way of looking at this is that what we’re really buying is time. Even if some new competitors 
springs up, buying Instagram, Path, Foursquare, etc now will give us a year or more to integrate 
their dynamics before anyone can get close to their scale again.” See Casey Newton and Nilay Patel, 
“Instagram can hurt us: Mark Zuckerberg emails outline plan to neutralize competitors”, The 
(i) **Potential competition**: as alluded to in the introduction, two merging firms may operate in adjacent (geographic or product) markets, but may contemplate entering each other’s market, and the right counterfactual to the merger would therefore be effective competition among them.\(^{19}\)

(ii) **Potential entry via innovation.** An insider is not active in the other merging party’s product market yet, but it is likely to be in the near future if the innovation (or investment) is currently making it successful. Several mergers in the pharmaceutical industry share this feature.\(^{20}\)

More generally, in sectors such as pharmaceuticals (see above) and agrochemicals (see the recent Dow/Dupont, Bayer/Monsanto, and Syngenta/ChemChina mergers) firms heavily invest in R&D in a number of product categories. In some of them they may be successful today, in others tomorrow. Thus the observation that firms are currently not actively marketing one product (or one drug) does not mean that they will not be able and have the incentives to do so tomorrow if a merger is not carried out.

(iii) **Recent entry.** Another instance where small market shares may not reflect the actual competitive constraints relates to cases where one of the insiders is a recent entrant in the market.

More generally, whenever one of the insiders is a recent entrant, looking at current market shares may under-estimate the competitive constraint represented by it, since a firm with a small market share may impose an important competitive constraint on the other firms prior to the merger. In this case, using the standard market share filter may lead to type-II errors.

In the digital sector, the vast majority of acquisitions by large players have not been investigated simply because they did not meet the turnover thresholds that in most jurisdictions would trigger notification. This is so because in digital industries firms often start monetising only when they have reached considerable customer base. For this purpose, notification thresholds based on the acquisition price seem to us a useful complementary screening device. Another possibility is to use a “share of supply” criterion as in the UK, Portugal, and Spain, whereby a merger should be notified if the market share of the combined entity were above

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\(^{19}\) Unfortunately, it is very difficult for AAs to find internal evidence showing market entry intentions. If some key assets (e.g., intellectual property, market data) are proprietary, difficult to replicate, and valuable in a particular market and possessed by a firm in an adjacent market, this may be an indication that market entry is likely by this firm.

\(^{20}\) For instance, in Novartis/GSK oncology, Pfizer/Hospira and Medtronics/Covidien, the EC found the merger would have suppressed drugs (or medical devices) which could have been approved. In each of these cases, one of the merging parties had already a drug in one (or more) particular market, while the other was in the process of passing the clinical trials. But examples go beyond the pharma industry. In General Electric/Alstom (General Electric/Alstom (thermal power - renewable power & grid business), Case M.7278, 8 September 2015.) Alstom was active in the segment of large gas turbines, but not in the segment of very large gas turbines. However, the EC found that Alstom was at a very advanced stage with the development of a very large gas turbine (the so called GT36) and, therefore, looking forward, a likely competitor in the market.
a certain threshold. For certain categories of products or services, for which societal harm from concentration (beyond the one measured by reduction in consumer surplus) seems particularly problematic, it may be desirable to have lower specific notification thresholds (e.g. for certain media content).

None of these criteria allow AAs to investigate acquisitions by systemic firms of some young start-ups that have neither substantial turnover nor built up a substantial user base or given other clear indications that they are likely to succeed—and thus their prospects are unclear and they may be a “cheap” target. Given the possible competitive risks that such acquisitions may have, we think that the proposal in the Furman report to oblige big tech firms with a special status to notify all of their acquisitions deserves careful consideration. While this proposal has been made in the context of big tech, we believe that it would be useful to be able to designate the status of systemic firm to any firm with a dominant entrenched position.

Implementing this proposal would not mean that these firms should never acquire smaller companies, but simply that the AAs should have the chance to look into these mergers and — where doubts arise — be able to assess whether possible pro-competitive effects outweigh the competition concerns. A more radical approach would be to implement a per se approach according to which systemic firms were to be prohibited from any acquisitions.

4. Assessment: Standard and burden of proof

We think that both the question of where to place the burden of proof, and what the standard of proof is, need some rethinking. When investigating a merger the AA has to balance efficiency gains with competitive harms. An improvement in a firm’s offering due to the merger may be seen to justify the acquisition of a potential competitor when the probability that the latter firm will become an effective competitor in the future is considered small. Even more worrying, the standard of proof for blocking a merger with a potential competitor appears to be that it is “more likely than not” that the acquired firm would become an effective competitor.

Further, Antitrust Authorities typically need to substantiate such a finding with documentary evidence which is unlikely to be easily obtained. For example, as observed by Jacques Crémer et al., “In the Facebook/WhatsApp merger, the Commission found no documentary evidence that WhatsApp was planning to become a fully-fledged social network in the future ... Such proof that the start-up is planning to enter the acquirer’s core market will generally also be difficult to

21 Facebook/Instagram and Google/Waze were reviewed by the UK authorities precisely because of the share of supply criterion used there. Similarly, the EU reviewed Facebook/WhatsApp because it was referred by the Spanish competition authority.

22 The Furman Report proposes to designate large digital platforms endowed with enduring market power on a bottleneck market with a “strategic market status” which carries certain obligations. The report does not specify the exact criteria to be used to designate certain platforms with such a status. See Jason Furman, Diane Coyle, Amelia Fletcher, Derek McAuley and Philip Marsden (2019), "Unlocking digital competition. Report of the Digital Competition Expert Panel".
obtain in other cases. Clear plans for doing so will rarely exist when start-ups are being bought up at an early point of their life.”

The well-established theoretical results on consumer harm from the removal of a potential or emerging competitor call for a policy approach whereby the approval of such mergers should not necessarily be the default option. Currently, it is the Antitrust Authorities (AA) which have the burden of proving that a merger is anti-competitive. Instead, when serious competition concerns are lurking, it would be more in line with economic thinking if the burden of proof was on the merging parties, which should demonstrate that they will achieve sufficient efficiency gains to compensate the upward pricing pressure created by the internalisation effect of the merger (or that barriers to entry are so low, or countervailing power so strong, that it is unlikely the merger would raise prices or harm consumers in other ways).

The current situation where the burden of proving that the merger is anti-competitive falls upon AAs also has the drawback that in order to substantiate a theory of harm the AA needs data and information which the merged entity possess. This may result in situations where the merging parties withhold information, or they transmit it partially and with delay. Reversing the burden of proof would alleviate this asymmetric information problem, since the agent who possesses the information will have all the incentive to make use of it (at least the information that it deems favourable for its objective).

We see particularly strong grounds for a reversal of the burden of proof in case one of the merging parties has an entrenched dominant position; i.e. that it is a systemic firm. The merging parties would then need to provide evidence that either the merger does not raise any significant competitive issue (which is likely to be the case when the target is a small company which is developing tools and/or may be acquired only for its human capital — and we would expect such cases to be the majority) or that expected efficiency gains (which include dynamic efficiency gains) are sufficiently large. A much more drastic policy is a per se rule against mergers involving a systemic firm. With this in mind, our proposal can be considered to be modest.

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24 This is notwithstanding the obligation of merging parties to provide accurate and non-misleading information (Article 14 of the Merger Regulation).

25 Fiona Scott Morton and co-authors suggest creating a digital authority (DA), a sector regulator which would also have additional power over merger review. "These specific merger regulations should require merging firms to demonstrate that the combination will affirmatively promote competition. This shifting of the burden of proof from the government (to prove harm) to the parties (to prove benefit) will assist the DA by placing the job of demonstrating efficiencies on the parties, who have a greater ability to know what they are." (Fiona Scott Morton, Pascal Bouvier, Ariel Ezrachi, Bruno Jullien, Roberta Katz, Gene Kimmelman, Douglas Melamed, and Jamie Morgenstern (2019). Committee for the Study of Digital Platforms, Market Structure and Antitrust Subcommittee, report. Stigler Center for the Study of the Economy and the State, p. 111) The ACCC (2019, p. 199), “Digital Platforms Inquiry”, Final Report, June 2019, contemplates that “it may be worthwhile to consider whether a rebuttable presumption should also apply, in some form, to merger cases in Australia. ... Absent clear and convincing evidence put by the merger parties, the starting point for the court is that the acquisition will substantially lessen competition.”
5. Conclusion

There is widespread concern that merger control is currently under-enforced in the EU (and in other jurisdictions). Of particular concern is that agencies rarely review (let alone prohibit) a merger because a potential competitor is removed.

Taking a tougher stance on mergers, of course, does not mean that every merger should be prohibited. It is sensible to use a safe harbour approach whereby mergers of two companies both having small enough size should be allowed without any investigation. Since horizontal mergers including those involving a potential competitor involving at least one "large" firm may well be anti-competitive, everything else given, such mergers would not fall under the safe harbour. Notification thresholds need to be adjusted to account for the fact that some firms delay monetisation even though they already enjoy a strong position in the market or are deemed to do so in the foreseeable future. Thus, mergers in which the acquisition price exceeds a certain threshold should also be notified. We recommend notification of all mergers for entrenched dominant firms that are systemic.

In many cases, future entry of one of the merging firms in a market in which the other merging firms is active cannot be ascertained. Thus, it is not certain that the firm can be classified as a future competitor. Since the harm from lessening competition may be severe and in order for merger control to have more bite in merger with potential competition, a balance-of-harm approach should be followed. When competition concerns are of particular significance (as in the case of the merger involving a systemic firm), we also see strong reasons for a reversal of proof.

The current US approach establishes a rebuttable presumption that the merger is unlawful if it goes beyond a certain level and increase in concentration indices. The difference to our proposal resides in the fact that requiring a material change in concentration to trigger the presumption would not allow to deal with cases of potential competition or entry via innovation. As such, our proposal is therefore closer to a recent law proposal by US Senator Amy Klobuchar whereby a merger is presumptively unlawful if merging parties’ size (measured by assets, sales or market capitalisation) is above certain thresholds.

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27 Relatedly, Baker, Farrell, Gavil, Gaynor, Kades, Katz, Kimmelman, Melamed, Rose, Salop, Scott Morton, and Shapiro, 2020, "Joint Response to the House Judiciary Committee on the State of Antitrust Law and Implications for Protecting Competition in Digital Markets", 20 April 2020, suggest as one of several options "Congress could specify presumptions of competitive harm that, for example, would apply in evaluating a dominant firm's exclusionary conduct or acquisitions."
We are well aware that the proposal of reversing the burden of proof (or establishing a presumption of illegality beyond certain thresholds) would need a change in policy, but we believe that this would be well worth the effort, e.g. in Europe by reforming the Merger Regulation (Council Regulation (EC) No 139/2004).