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Unbundling GE/Honeywell: the Assessment of Conglomerate Mergers Under EC Competition Law

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Introduction

Conglomerate mergers are mergers between firms that have no existing or potential competitive relationship either as direct competitors or as suppliers and customers. Most frequently, conglomerate mergers involve suppliers of complementary products or of products belonging to a range that is generally sold to, and requested by, the same set of intermediate or final customers.

It is generally claimed that because conglomerate mergers do not result either in direct horizontal overlaps or in vertical relationships, they should be viewed as having a positive or at least neutral effect on competition. Whilst it can be reasonably accepted that conglomerate mergers may not be anti-competitive per se, the conglomerate aspects of mergers may constitute an additional factor, either aggravating or mitigating, to existing horizontal and/or vertical effects. A careful approach needs then to be taken by antitrust authorities in the assessment of the possible exclusionary effects of conglomerate mergers on competitive conditions. In general, conglomerate mergers will raise concerns when they make the leverage of market power possible, having thus as their effect or object to foreclose the market to effective competition. The resulting competitive harm stems from the accumulation

of substantial market power across complementary products or product ranges which, not being based on normal business performance or competition on the merits, may substantially reduce consumers' choice and ultimately lead to higher prices and a loss of welfare. Conglomerate analysis has, therefore, to proceed with the subtle distinction between competition on the merits and market exclusion based on anti-competitive aims. As far as the exclusionary effects of conglomerate mergers are concerned, there is a clear parallel to be made with vertical effects, since in economic terms the exclusion mechanism in the context of vertical integration functions in a similar way as in the context of a merger of complements.

Although there is no explicitly stated framework for the analysis of conglomerate mergers either under the EC Merger Regulation or under other jurisdictions, there is general agreement that the analysis of conglomerate effects has to undergo a certain number of steps. Several conditions relating, amongst others, to the nature of the products concerned, the nature of the industry in question and the degree of market power held by the merging parties pre-merger, have to be examined.

First, the definition of the individual products and/or services as well as their evaluation in the combined product range are key elements in the analysis of conglomerate mergers. The products markets in conglomerate mergers are usually neighbouring or related markets - a concept which is intended to describe a demand side linkage between markets, i.e. a significant degree of commonality in terms of buyers served. The clearest but not the only example of such a linkage would be complementary or slightly substitutable products. Under certain circumstances, the combination of such products alters the structure of the markets concerned thus giving the merged firm the ability and the economic incentive to change its pricing behaviour. This so-called Cournot effect of conglomerate mergers stems from the fact that they enable the merged entity to internalise price externalities arising from the fact that the combined products are technical complements (e.g., one cannot function without the

other), economic complements (e.g., products which are consumed together, etc.), commercial complements (e.g., when they form part of a range which downstream agents need to carry, etc.).

Second, when the merging firm enjoys market power in one or more of the complementary products in the range, a change in its pricing behaviour may be motivated by the possibility to leverage its existing market power into one or more of the products in the combined product range. Complementary products sold to the same customers and viewed by the latter as constituting an essential part of their requirements are more likely to make leveraging more profitable. In this case, leveraging may translate into various types of practices, such as for instance product tying, which may be based on pressure or incentives vis-à-vis downstream agents: for instance, commercial tying in the form of a refusal to supply; mixed bundling based on the variation in the pricing structure in the product range; technical tying and so forth. In addition to that, where the merger brings about an accumulation of financial strength, cross-subsidisation and predation may facilitate the pricing flexibility in the product range and thus constitute an additional motivation for the leveraging of market power.

Third, the assessment of conglomerate aspects also involves an examination of the specific characteristics of the markets concerned. For instance, the existence of buyer power may act as a constraining factor to the leveraging of market power. The same applies to the existence of competing suppliers capable of proposing alternative and equally attractive product ranges. Moreover, in industries displaying high entry barriers, high sunk costs, long payback or break-even periods, imperfect capital markets, intensive R&D and high investment costs, the competitive constraint coming from competitors may not be sufficient to counter the incentive and ability of the merged firm to leverage its pre-merger market power. The existence of significant financial strength on behalf of the merged firm may, in such a case, be an aggravating factor. However, financial strength has to be analysed on a case-by-case and on

an industry-by-industry basis, to determine whether it is an important element of the overall conglomerate analysis. The assessment of financial strength has nothing to do with any a so-called “big is bad” argument; indeed, the Commission has never pursued any policy in this direction and has never challenged mergers on the basis of the sheer size of the merging companies.

Fourth, the existence of market power or dominance in at least one of the pre-merger complementary products is a necessary condition for the likelihood and the profitability of leveraging practices. This is more so when both merging firms have strong market positions in their respective markets, such as for instance in the recent GE/Honeywell case, where a dominant firm in one of the complementary markets proposed to acquire the leading supplier in the other market. To date, the European Commission has challenged the leveraging effects of conglomerate mergers only when market power has pre-existed before the merger in at least one of markets composing the combined product range.

Some forms of post-merger pricing in conglomerate mergers may act in favour of downstream agents. For instance, mixed bundling can create incentives to customers in the form of rebates and other advantages. However, such advantages can be short-lived and take the form of strategic pricing. To the extent that pro-competitive efficiencies may constitute one of the reasons to approve a merger, antitrust authorities have to proceed with a critical analysis of the possible efficiencies they are likely to produce. When significant efficiencies are claimed, antitrust authorities will have to establish in particular whether such efficiencies are real – that is, likely to be structural and permanent and ultimately to reduce the marginal costs of producing/distributing the products and/or services in a sustainable way so that the benefits be truly passed on to the consumers. They will then have to analyse whether the claimed efficiencies are merger-specific and sufficient to counter the effect on price that the potential foreclosure effects of market power leveraging is likely to produce. Finally, they will have to

make the trade-off between efficiency gains and losses from the restriction of competition and ascertain that the initial efficiencies are not later extinguished through the elimination of competition and subsequent price increases.

Types of leveraging effects

As mentioned before, conglomerate mergers raise competitive concerns when they can afford the supplier of a range of complementary products the possibility and the economic incentive to leverage its market power in one of complements into another. This leverage of market power may take one or a combination of the forms described below.

Commercial tying based on pressure to downstream agents

A conglomerate merger may enable the merged firm to pressure customers through the threat to refuse to supply one of the products in the range unless they also buy other products in the range or through the obligation imposed on customers to buy the whole range (i.e., full-line forcing). The possible anti-competitive effect of this type of product tying relies on the ability and the incentive of the merged firm enjoying market power in one market, the “tying market”, to leverage this market power into another market, the “tied market”.

The concept of the creation or strengthening of market power in non-horizontally or non-vertically related markets as a result of this type of product tying is not novel in EC antitrust analysis. Product tying has been analysed in the practice of the European Commission and the case law of the European Court of Justice on various occasions, either under Article 82 of the EC Treaty (abuse of dominant position) or under the EC Merger Regulation.

Article 82(d) of the EC Treaty provides that an abuse may consist in making the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such

contracts. This provision refers to situations where a firm which holds a dominant position in one product forces its customers to purchase this product together with other products in which it is not necessarily dominant. Its objective is to prevent the distortion of competition in the tied product market by reducing the competitive thrust of competing suppliers active in this market, eventually forcing them to exit that market. The classic example of product tying under Article 82 is found in the Hilti case.¹ The case concerned a company trading in nail guns and their accessories (cartridge strips and nails) which attempted to eliminate independent producers of nails compatible with its guns by, first, selling its cartridge strips only to those customers who agreed to buy its own nails and, secondly, by reducing the discounts to the customers who bought its cartridge strips and compatible nails from competing suppliers. The Commission considered that this form of product tying constituted an anti-competitive exclusionary practice.

In another case (Tetra Pak II), the Court of First Instance² and the Court of Justice³ confirmed the Commission's finding that Tetra Pak had committed abuses in the markets for non-aseptic packaging machines and non-aseptic cartons (the "tied markets"), through Tetra Pak's dominant position in the markets for aseptic packaging machines and aseptic cartons (the "tying markets"). The leverage of market power from the "tying markets" to the neighbouring "tied markets" through product tying was justified by a series of factors, such as for instance the fact that Tetra Pak held a leading position in the "tying markets", the strong links existing between the two markets, the fact that the products in both markets were used for the same

¹ Eurofix-Bauco/Hilti, OJ L65/19 (1988) (Comm'n) upheld in Hilti AG v. Comm'n, T-30/89, 1991 ECR II-1439 (CFI) and in Hilti AG v. Comm'n, Case C-53/92P, 1994 ECR I-667 (CJ)

² Tetra Pak International v. Comm'n, T-83/91, 1994 ECR II-755 (CFI)

³ Tetra Pak International v Comm'n, Case C-333/94P, 1996 ECR I-5951 (CJ)

purposes (i.e., packaging the same final products) and that a substantial part of Tetra Pak's customers and competitors operated in both markets.

Under the EC Merger Regulation the Commission has challenged mergers on the basis of leveraging of market power through product tying in several cases concerning consumer goods. In its decision in the case Coca-Cola/Amalgamated Beverages GB⁴, the Commission examined whether the constitution of a broad range or portfolio of soft drink brands would confer on the Coca-Cola Company the possibility to use its beverage portfolio to its advantage, for instance by leveraging its strong position in Coca-Cola (the "tying market") into other products of the portfolio. In the same sector, the Commission examined whether the constitution of a portfolio of carbonated soft drinks, packaged water and beer might give "each of the brands in the portfolio greater market power than if they were sold on a stand alone basis" and subsequently concluded that such a portfolio would strengthen the existing dominant position of one of the firms in the "tying market".⁵

In the Guinness/Grand Metropolitan⁶ case the merger analysis focused on the non-horizontal effects resulting from the formation of a wide portfolio of product brands across various categories of spirits, which constituted separate but closely-related product markets. The assessment was based on the finding that when elements of market power are combined, the whole may be greater than the sum of the parts. Therefore, although individual leverage possibilities might have existed prior to the merger, the combined leverage possibilities post-merger, through product tying, became greater than the sum of the individual possibilities pre-merger. The decision outlined some of the advantages that a comprehensive portfolio of goods may grant to the merged firm. For instance, the bargaining position of the merged firm

⁴ Coca-Cola/Amalgamated Beverages GB, OJ L218/15 (1997)

⁵ The Coca-Cola Company/Carlsberg A/S, OJ L145/41 (1998)

in relation to customers would become stronger owing to the fact that the broader offering of its products would account for a substantial part of the customers' requirements, thus making the implicit or explicit threat of a refusal to supply more potent. The Guinness decision set out certain conditions under which a combined product portfolio may result in the creation or reinforcement of dominance, such as for instance, whether downstream agents purchased a range of products among which the combined portfolio accounts for a significant proportion; whether market power existed in one or more "tying markets" (i.e., leading brands of spirits, also referred to as "must stocks") among the products constituting the portfolio; the market shares of the various other products of the portfolio, in relation to the shares of competitors; the relative importance of the individual product markets in the portfolio in terms of sales in the total sales of spirits; the relative strength of competitors' individual products or portfolios; and finally, the prospects for the exercise of countervailing buyer power and for potential competition through entry or expansion.

In all these cases, the Commission considered the ability and incentive of firms to leverage power in one market to the benefit of a product in another complementary, non-competing but closely related market. The main criticism of product tying as a profitable exclusionary practice has been based on the theory developed in the so-called Chicago School of thought, i.e., that there is only one monopoly profit to be made and the firm active in the tying market can make this profit simply through its pricing in this market. This line of thinking is, however, based on theoretical assumptions that are not always met in real life, such as that the "tied market" is purely competitive or that the two products are used in fixed quantities. The most recent line of thinking is that if competition in both markets is imperfect, tying can under certain conditions change the market structure of the tied market by excluding or eliminating

⁶ Guinness/Grand Metropolitan, OJ L288/24 (1998)

rivals.⁷ These conditions have generally been met in the Commission's assessment of product tying under either Article 82 EC or the Merger Regulation. Thus the condition of the existence of market power in the tying market has been met in the finding of a dominant position (e.g., in nail guns in Hilti or in Coca Cola Classic in the Coca Cola cases) or in the existence of a must-stock brand (e.g., in Guinness and in the Coca Cola cases). Indeed, it can be reasonably be argued that a firm which lacks market power in the tying market may not have the ability to leverage such market power to the tied market. Another condition is that the firm must have the economic incentive and ability to commit to a tying strategy. For instance, the Commission may assess the credibility of the threat to refuse to supply customers unless they buy both the tying and the tied products or to impose on them full-line forcing. In general, the refusal to supply the tied product separately from the tying product may not be credible where the firm faces a disproportionate risk of failing to sell both products, thus losing profits in both product markets. For instance, in the presence of "must-stock" products, the Commission considered that the inelasticity of demand of customers vis-à-vis such products makes that threat credible. In merger cases, the Commission also assesses a third condition, namely whether tying has as a consequence the reduction of competition in the markets, as a result of the foreclosure, marginalisation or elimination of competing suppliers. For instance, in Guinness and in the Coca Cola cases, the Commission found that competing suppliers would be permanently foreclosed from a substantial amount of market outlets, as a result of tying practices on behalf of the merged firm.

⁷ NERA Competition Brief, Beyond Bork: New Economic Theories of Exclusion in Merger Cases, August 2001

Commercial tying based on pricing incentives

Conglomerate mergers may also change the pricing behaviour of the merged firm as a result of the constitution of a wide range of product offering. In such a case, complementary products may be sold together at a price which, owing to the flexibility of the merged firm in structuring discounts across the combined product range, is lower than the price charged when they are sold separately. As a result of the combination of a broad range of complementary products, the merged firm may have the financial ability and incentive to cross-subsidise discounts across the products of the range, thus granting rebates which are conditional on the purchase of all products of that range. Such a practice enables the firm to lock-in its customers, notably through the possibility to price discriminate vis-à-vis those who reveal their preference to buy the whole range or separate products thereof. The Court of Justice examined under Article 82 the grant of discounts which were conditional on the customer's purchasing the whole range of the firm's products (i.e., vitamins) and considered them as constituting an exclusionary abuse when performed by a dominant undertaking.⁸ In the same spirit, in Michelin⁹ the Court stated that "no discount should be granted (by a dominant firm) unless linked to a genuine cost reduction in the manufacturer's costs". The Court pointed out that competing suppliers of automobile tyres may be foreclosed as a result of such practices owing to the fact that customers would be unlikely to switch suppliers or deal with other suppliers at any point during the reference period (one year) for fear of not qualifying for the rebate. As in the case of product tying, the underlying concern of mixed bundling is that such a practice may have a tying effect on customers, thereby considerably foreclosing the market to competing suppliers.

⁸ Hoffman-La Roche v. Comm'n, Case 85/76, 1979 ECR 461 (CJ)

⁹ Nederlandsche Baden-Industrie Michelin NV v. Comm'n, Case 322/81, 1983 ECR 3461 (CJ)

This is particularly true in the case of conglomerate mergers, where competing suppliers of individual, stand-alone products are unable to replicate the post-merger behaviour of the merged entity due to the limited number of products in their portfolio. Thus, in Guinness, the Commission considered that the constitution of a broad portfolio of spirits would give the merged firm the flexibility to structure prices, promotions and discounts and have a reasonably greater potential for product tying. In a more recent decision in the spirits industry,¹⁰ the Commission identified portfolio concerns stemming from the fact that “post-merger, if one or more additional leading brands are added to an existing range this may strengthen the overall position of the brand owner. Greater diversity of the product range offered including leading brands improves the position of the brand owner by giving him a series of leading products which may be sold together and used to promote his secondary brands”.

Under this type of commercial tying, the general level of demand for the products in the product range can be expected to increase, in the sense that a decrease in the price of one of the complementary products may increase the demand for the other complements in the range. For such an increase in demand to be profitable, the merged firm may render the price reduction contingent on customers taking the whole range of complementary products from it. This type of commercial tying may produce a short term welfare increase for those customers which chose to buy the range at a reduced price, and a welfare reduction for those which prefer to buy stand-alone products at higher prices. However, in the long term, welfare may be adversely affected when competitors are foreclosed, marginalized or eliminated from the market and when subsequently the merged firm has the ability to raise prices, without fearing re-entry. Such concerns were considered by the Commission in the Pernod Ricard/Diageo/Seagram Spirits decision as stemming from the fact that a “greater portfolio

¹⁰ Pernod Ricard/Diageo/Seagram Spirits, Decision of 8 May 2001 in case COMP/M.2268 (Comm’n)

diversity and the subsequent listing of the parties weaker brands reduce the opportunities for competing suppliers whose products may be then de-listed by retailers.”

Conglomerate mergers may render this type of tying possible as a result of cross-subsidisation between the different products in the combined product range. In addition, where the merger brings about significant financial strength, the ability of the merged firm to cross-subsidise discounts across the complementary products in the product range may also come from profits made on products outside that range.

Technical tying

Conglomerate mergers may also produce anti-competitive effects when they enable the merged firm to engage in technical tying. Technical tying may become possible when, as a result of the merger, the complementary products become available only as an integrated system that is incompatible with competing individual components. Such a practice may be found in industries which manufacture intermediate products which are subsequently assembled either by the final buyer or by intermediate downstream agents (e.g., in the automotive, aerospace, computer industry, etc.). When the merging parties enjoy market power in one or more of their complementary products, technical tying can have the effect of foreclosing competing suppliers of individual components, by denying them the possibility to sell their intermediate products alongside the other products of the merged firm. This can potentially reduce their profitability and adversely affect their incentives to compete. In a recent case, the Commission examined whether the merged entity could engage in technical tying by making its complementary products (i.e., satellite interfaces and launchers) incompatible with competing products.¹¹ The Commission found that in the absence of market

¹¹ Boeing/Hughes, not yet published (Comm’n)

power in either of the complementary products and in the presence of buyer power the merged firm would not have the ability to engage in technical buying.

On the basis of the above description of the various forms of leveraging practices, it can be concluded that conglomerate mergers may produce anti-competitive effects under certain well defined circumstances.

Conglomerate mergers may result in the creation or strengthening of a dominant position through the leverage of market power from one product market into another, closely related product market, where market power does not necessarily exist before the merger.

The extent of the competitive harm of conglomerate mergers depends on the industry concerned. Thus, conglomerate mergers in industries which display imperfect competition, high sunk costs, high entry or expansion barriers, imperfect capital markets and so forth, are more likely to lead to the permanent exclusion of competitors and the subsequent monopolisation of the market by the merged firm. Conversely, conglomerate mergers may not lead to competitive harm when the merging firms lack sufficient market power or when the quality and immediacy of the competitive response of rivals can make the merged firm's leveraging practices unprofitable. Finally, conglomerate mergers may fall short of competitive harm when buyers possess a sufficient amount of countervailing power and when, on balance, the benefits from significant and substantial efficiency gains clearly and unconditionally outweigh the potential competitive harm.

The assessment of conglomerate effects in the GE/Honeywell case

Against that more theoretical and policy background, it is now time to address the substance of the case that has probably focused the most attention over the last few months if not years: the GE/Honeywell transaction.

I'm sure you will recall that it was in the middle of an intense press coverage and political debate on both sides of the Atlantic that the European Commission declared the proposed merger between GE and Honeywell incompatible with the common market on the 3rd of July.

This decision came at the end of an in-depth investigation which resulted in the finding that the combination of the leading aircraft engine maker with the leading avionics/non-avionics manufacturer would create and/or strengthen dominant positions on various of the relevant markets in which the merging companies are active.

There has been and still is much controversy about the reasoning of the Commission and its incentives for blocking what was once announced as the largest industrial merger ever.

Now that some, but understandably not all, of the dust has settled and that the Commission decision has been made public via the Commission's website, it might be the right time to have a deeper look at it in order to understand its basics, set the record straight as far as its rationale is concerned and, if possible, put an end to the misunderstandings that have surrounded it for a long time now.

Let me start off by shaking the audience a little bit and declare that, in its effects, the GE/Honeywell merger, as analysed by the Commission, is not a "portfolio effects" case. It is a regrettable, indeed, that many antitrust and other commentators rushed to criticise the

Commission for having applied “off-the-wall” theories – undoubtedly referring to a “portfolio effects” analysis – which, as I explained before, the Commission has already used on under certain circumstances.

Indeed, while there is no doubt about the conglomerate nature of the case given both the complementary nature of the products and services involved as far as aerospace is concerned, as well as the common customer base of the parties, the effects identified by the Commission rest more with the implementation and transfer of GE’s toolkit for dominance to Honeywell’s products rather than with genuine portfolio effects.

Before I explain in more detail the “red line” of the Commission’s reasoning, let me stress the critical importance of this very message as being an attempt – hopefully successful and comprehensive, within the limits of the respect of business secrets and of the sub judiciae status of the case – to bring to light the facts and arguments used by the Commission’s in the GE/Honeywell case.

The Commission’s case in a nutshell

The core factor of the Commission’s competitive assessment of the merger is the combination of GE’s financial strength and vertical integration into aircraft purchasing, financing and leasing with Honeywell’s leading positions on various product markets, such as corporate jet engines, avionics and non-avionics products.

Similarly to how GE has built its dominant positions on the large civil engine markets, the Commission’s assessment of the case led to the conclusion that it wouldn’t take long for GE to transform Honeywell’s already strong leadership on the markets for corporate jet engines, avionics and non-avionics products into genuine dominant positions.

GE's toolkit for market dominance

GE's current dominant positions on the markets for engines for both large commercial and large regional jet aircraft indeed result from the combination of a series of factors that, following the transaction, would have been made directly available to Honeywell, when not already available to Honeywell, such as its leading market position.

Together with GE's consistently high and increasing market shares for engines, the factors that contribute to GE's dominance are its vertical integration into aircraft purchasing, financing and leasing, its financial strength through GE Capital, GE's financial arm, as well as its strong position on the aftermarket services.

GE Capital was a factor

Against that background, and quite apart from its high market shares, you will agree that GE, which by the way has the world's largest market capitalisation¹², can be characterised as a rather unique company. Indeed, GE is not only a leading industrial conglomerate active in many areas including aerospace and power systems, but also a major financial organisation through GE Capital, which contributes around half of the GE Corporation consolidated revenues and manages over USD 370 Bio, more than 80% of GE's total assets¹³.

The Commission's investigation confirmed that GE Capital offers the GE business enormous financial means almost instantaneously and enables GE to take more risk in product development programmes than any of its competitors. The Commission's investigation further

¹² Market capitalization of USD 480 Bio as of 1 June 2001 (far greater than any other company active in the commercial aircraft market such as Boeing with around USD 56 Bio, UTC with USD 39 Bio and RR with USD 5 Bio).

confirmed that this ability to absorb product failures in an industry characterised by long term investments is critical.

The importance of the financial strength in this industry, through the heavy discounts on the initial sales of engines which is a practice that resulted in moving the break-even point of an engine project further away from the commercial launch of an aircraft platform, helped GE, thanks to its enormous balance sheet, to establish its dominant position. Indeed, by increasing this delay in the inception of cash flows and consequently by increasing its competitors' needs to resort to external financial means further raising their leverage¹⁴ and resulting borrowing costs¹⁵, GE made its competitors – most of which are specialised single-product companies – very much vulnerable to any down cycle or strategic mistake.

More importantly, the Commission's investigation revealed that, thanks to its financial strength and incumbency advantages as an engine supplier, GE can afford to provide significant financial support to airframe manufacturers under the form of platform-programme development assistance that its rivals have not been, historically, in a position to replicate. GE has indeed used this direct financial support to obtain exclusivity for its products on those airframes that it has financially assisted¹⁶, thereby depriving permanently competitors from access to such airframes.

¹³ If GE Capital were an independent company, it would, on its own, rank in the Top 20 of the Fortune 500 largest corporations.

¹⁴ I.e., the Debt/Equity ratio.

¹⁵ One illustration of this significant competitive advantage enjoyed by GE over its industrial rivals resides in its AAA credit rating, which extends to all its subsidiaries and enables them to raise cheaper and quicker finance than competitors.

¹⁶ GE has secured a total of ten exclusive positions out of the last twelve that were granted by airframe manufacturers. GE did not take part in the other two.

GE's enormous financial capacities also contribute to further grow and strengthen its position on the very lucrative part of the engine business by investing large amounts of money for several years into the aftermarket through the purchase of a significant number of repair shops all over the world.

GECAS was a factor

Let me now address another key factor contributing to GE's dominance, which is its vertical integration into aircraft purchasing, financing and leasing activities through GE Capital Aviation Services ("GECAS"). You all know by now that GECAS is the largest purchaser of new aircraft, ahead of any individual airline or other leasing company¹⁷ and is reported to have the largest single fleet of aircraft in service, as well as the largest share of aircraft on order and options.

As you are also probably aware, unlike any other independent leasing company, GECAS does not select equipment on the aircraft that it purchases in accordance with market demand. As a result of GECAS' policy of selecting only GE engines when purchasing new aircraft, 99% of the large commercial aircraft ordered by GECAS are GE-powered¹⁸.

¹⁷ As far as large commercial aircraft are concerned, GECAS accounted for a little over 10% of Boeing's order book with 135 aircraft on order at the time of the Commission's investigation. The figure was equivalent for Airbus with a total GECAS backlog of some 138 aircraft. Southwest Airlines was reported to have the largest backlog of all individual airlines with a total of 144 large commercial aircraft. The next largest order backlog from an airline was that of Delta with 108 aircraft on order.

¹⁸ The remainder is accounted for by 8 Boeing 757s for which GE has no engine on offer.

The Commission's in-depth investigation indicated that GECAS has the incentive and the ability to enhance the market position of GE Aircraft Engine division ("GEAE") through various means. As a launch customer¹⁹, GECAS can influence the selection of aircraft equipment by the airframe manufacturers and therefore, in combination with other GE features, tilt the balance in favour of it being retained as the exclusive equipment and service supplier.

Unlike any other engine manufacturer, GE can afford to pay in order to obtain exclusivity and hence capture aftermarket, leasing and financial revenues. From an airframe manufacturer's perspective, selecting GE can give access the largest customer base of airlines and can secure a significant, either launch or boost, order of its aircraft by GECAS.

GEAE's competitors have been unable to offer comparable launch or boost orders and purchases to airframe manufacturers. The role of GECAS as a launch or boost customer has proven particularly effective in obtaining access/exclusivity to new aircraft platforms, as illustrated by GE's exclusive position on the Boeing 777X. In addition, GECAS has also proven to be a very effective tool in strengthening GE's position with airlines on those platforms where there is engine choice.

Our market investigation further showed that GECAS has the ability to standardise airlines' fleets around GE-powered aircraft, hence persuading airlines that would not otherwise have leased a GE-powered aircraft to accept such an aircraft. Finally, our investigation confirmed that the ability of GECAS to shift market shares by seeding airlines with GE-powered aircraft has, owing to the constraints of fleet and equipment commonality, a multiplying effect – indeed,

¹⁹ GECAS is one of the two leasing companies that operate as launch customers as these companies can order multiple aircraft at one time, and wait the extra time for delivery of a new airframe.

such airlines will continue to purchase GE engines in the future, therefore multiplying GE's share of the market.

Let me be clear – because this is key to the Commission's reasoning – that no other engine manufacturer has the vertical integration, size and financial strength to respond to such offers by being based only on competition on the merits. As a result, by using the purchasing leverage of GECAS, GE has been able to shift jet engine market shares to the benefit of GEAE.

The Commission could not share the contention that the influence of GECAS could be replicated easily and rapidly by GE's competitors through, inter alia, the setting-up of their own aircraft leasing subsidiaries. The Commission's investigation therefore confirmed that such a counter-move on behalf of competing engine manufacturers could not constrain GE's leadership on the engines markets.

Interim conclusion on GE's ability to become dominant

Given the nature of the jet engines market, characterised by high barriers to entry and to expansion, GE's incumbent position with many airlines, its incentive to use GE Capital's financial power with customers, its ability to leverage its vertical integration through GECAS, the limited countervailing power of customers and the comparatively weaker position of its rivals, GE was considered to be in a position to behave independently of its competitors, customers and ultimately consumers and thus to be a dominant firm on the markets for large commercial jet aircraft engines and for large regional jet aircraft engines.

The effects on Honeywell, at the core of the Commission Decision

By extending those GE features that I just described to Honeywell's aerospace products, the proposed merger would have led to the creation of dominant positions on several markets as a

result the combination of Honeywell's leading market positions with GE's financial strength and vertical integration in aircraft purchasing, financing, leasing and aftermarket services.

An example: SFE products

Take for example SFE products. Supplier-furnished equipment are products selected on an exclusive basis by the airframe manufacturer and supplied as standard equipment for the life cycle of an aircraft. Consequently, for a supplier of SFE, its initial selection on a platform can guarantee a long-term source of revenues. Following the proposed merger, Honeywell would have immediately benefited from GE Capital's incentive and capability to secure exclusive supply positions for its products, thereby excluding permanently rivals from a large chunk of the market.

In addition to that, and similarly to GE engines, Honeywell's products would have also benefited, as a result of the proposed transaction, from the role of GECAS as a significant purchaser of aircraft and from its business practices to promote GE products and services. Post-merger, GECAS would indeed have had a strong incentive to extend its GE-only policy from engines to avionics and non-avionics.

Furthermore, thanks to GE's strong generation of cash flows resulting from the conglomerate's leading positions on several markets, following the merger Honeywell would have been in a position to benefit from GE's financing surface and ability to cross-subsidise across its various business segments, including the ability to engage in temporary predatory behaviour.

In the light of these elements, the strategic use by GE of the considerable market access enjoyed by GECAS and of the financial strength of GE Capital in favour of the products of Honeywell would have positioned Honeywell as the dominant supplier on the markets for

SFE avionics and non-avionics where it already enjoyed leading positions with high market shares.

By the same token, rival avionics and non-avionics manufacturers would have been deprived from future revenue streams generated by the sales of the original equipment and spare parts. As I already mentioned, future internally generated financial means are key to this industry, as they are needed to fund development expenditures for future products, foster innovation and enable possible leapfrogging. By being progressively marginalised, as a result of the integration of Honeywell into GE, Honeywell's competitors would have been deprived of a vital source of revenue and see their ability to invest for the future and develop the next generation of aircraft systems substantially reduced, to the detriment of innovation, competition and thus consumer welfare.

This is the kind of effects that were at the heart of the Commission's concerns. I believe they had little to do with a genuine "portfolio effect" theory.

Related Elements

Now that I hope you have gained a better insight into the Commission's analysis which is not just relying on bundling and portfolio theories, let me address two further elements which are important to understanding the Commission's case.

Exit of Competitors

A lot has been said about GE and Honeywell's competitors throughout the entire review process of this case by the Commission. One particular feature that was extensively debated had to deal with their so-called exit or disappearance from the market. While straight exit is not a remote or impossible event this market, I would like to make clear that exit of

competitors, in the sense the Commission has interpreted it, does not require a general shut-down of the competitors' activities, or a total disappearance of their corporate existence.

Exit, as it must be read in the Commission's GE/Honeywell decision, may indeed occur in relation to specifically identified product markets rather than to a broader industry, such as aerospace, as it has often been advanced by critics. What the Commission argued, however, was not that rivals would vanish shortly after the implementation of the merger, but rather that some of them would make rational economic decisions to no longer invest in some of the segments of the industry where they had been active. Taking this type of decisions is nothing unusual in the business world. Companies tend to re-orientate their activities as a general response to evolving market conditions. They pull back from specific segments of the markets and re-focus on other markets where they can still make a reasonable living. This is precisely what the Commission has shown in its analysis of the GE/Honeywell merger, by establishing a high likelihood that GE and Honeywell rivals would withdraw from specific segments (e.g., engines for large commercial aircraft, or specific avionics and non-avionics) because of their inability to compete on the merits in those specifically identified markets which, from an antitrust perspective, constituted our relevant product markets. Eventually, such stepping out would obviously have resulted in a substantially lessening of competition.

Antitrust protects competition, not competitors

It would therefore be misleading to accept unconditionally such overly simplistic positions that competitors should never be the focus of antitrust worries and that if inefficient competitors were driven out of the market, even then consumers would be better off overall.

I believe that most of you will agree that the purpose of merger control is to prevent the accumulation of excessive market power on behalf of one firm or a small number of firms. You should also agree that merger control needs to be concerned with the preservation of competitive market structures, which may then benefit the consumer as a result of competition. Having said that, I would hope that you also agree that where competitors are squeezed out, marginalised or driven out of the market, they cannot oppose any credible competitive constraint to the dominant merged firms. In other words, and subject to exceptional cases, such as natural monopolies, there can be no effective competition without competitors. This is the reverse side of the so frequently heard adagio that antitrust is not about protecting competitors.

While there is nothing wrong in admitting that the competitive process is about encouraging the more efficient firm to grow at the expense of the less efficient, it might be prudent for antitrust authorities not to adopt unconditionally such a Darwinian theory on the evolution of species, whereby competitors that are unable or unwilling to meet the new competitive environment created through a conglomerate merger would better leave the market. This argument is quite general in that it suggests that in every single industrial sector, inefficient competitors will be driven out of the market and subsequently replaced by more efficient ones. Overall, this alternation between inefficient and efficient competitors will leave no room to the merged firm to increase its prices profitably and sustainably. However, this argument disregards the realities of certain markets, where market exit may not be followed by new entry. In such a case, protecting the competitive structure of an industry should not be confused with the protection of inefficient competitors. This was precisely the case with the GE/Honeywell merger, where high entry barriers and very long industrial cycles did not favour entry. Once rivals are marginalised or expelled from the market, they would remain in

that position on a lasting basis. And this is precisely what we analysed and confirmed during our in-depth investigation.

A false efficiency debate

The Commission has been under criticism that it looked only at the creation of market power as a result of the proposed merger, but not at any efficiencies that the combination of GE and Honeywell would have brought about. Let me clarify the Commission's position on this debate.

First, I would like to mention something that most of the antitrust community will agree with. It would be rather far-reaching to accept unconditionally that conglomerate mergers promote efficiency and aggressive competition that benefit consumers. While it is true that conglomerate mergers may have the potential to generate efficiency gains in individual cases – as it may be the case with any other type of merger – there can be no presumption that such mergers generally and automatically generate such efficiencies.

A comparison between real, merger-specific efficiencies and medium to long-term damage to the market has to be undertaken – and of course, there is a judgement call here, which antitrust authorities have to undertake.

Based on that, I wish to categorically reject the criticism that the European Commission does not recognise an efficiency defence. More specifically in the GE/Honeywell case, the merging parties have consistently argued that the merger would not create the type of efficiencies that antitrust authorities have to rely upon – that is, a long-term and structural reduction in the marginal cost of production and distribution, which comes as a direct and immediate result of the merger, which cannot be achieved by less restrictive means and which reasonably will be passed on to the consumer on a permanent basis, in terms of lower prices or increased quality.

On the contrary, the merging parties explained that the merger would create cost savings, which can be naturally expected from any merger, as a result of the elimination of duplication. However, cost savings should not be equalled to merger-related efficiencies. They do not automatically lead to sustainable and structural price reductions, but rather to increased margins for the firm, which cannot automatically be expected to be passed on to consumers.

Was product bundling an efficiency or an exclusionary practice ?

While the effects resulting from the implementation of GE's financial strength and vertical integration into aircraft financing, leasing and purchasing constitute the heart of the Commission's decision as I just explained at length, I must recognise that the merged firm's incentive and ability to foreclose competition through leveraging practices, such as bundling and tying, would have also contributed to the creation and strengthening of dominant positions on several of the relevant markets such as for example the markets for BFE and SFE-option avionics and non-avionics.

Indeed, given the parties' dominant or leading positions in their respective markets, and the wide combination of complementary products that it could have offered, the merged entity could have engaged in a number of foreclosure practices on the markets for BFE and SFE-option avionics and non-avionics.

Sales of BFE and SFE-option products are made to airlines on a regular basis, in particular each time an airline replaces or complements its fleet of aircraft. On each of these occasions, the merged entity could have foreclosed the selection of Honeywell's competing BFE and SFE-option products by selling its own products, for instance, as part of a broader package comprising engines and GE's ancillary services such as maintenance, leasing, finance, training, and so forth.

As a result of the proposed merger, the merged entity would have had the financial and technical ability as well as the economic incentive to price its packaged deals in such a way as to induce customers to buy GE engines and Honeywell BFE and SFE-option products over those of competitors, thus increasing its combined share on both markets. This would have occurred as a result of, *inter alia*, the ability of the merged entity to cross-subsidise strategic price reductions across the products composing the packaged deal.

In the short term, the merger would have affected suppliers of BFE and SFE-option products. As BFE products are sold and purchased on a regular basis, the merged entity's packaged offers would manifest their effects immediately after the consummation of the merger. Because of their lack of ability to match the bundled offers, rival component suppliers would lose market shares to the benefit of the merged entity and experience an immediate damaging profit shrinkage. As a result, the merger was likely to lead to market foreclosure on those existing aircraft platforms and subsequently to the elimination, or a substantial lessening, of competition in these areas.

In the light of the above, when assessing efficiency claims in conglomerate mergers it is vital to make to right trade-off, as such mergers may give rise, among other effects, to leveraging practices, among which product bundling. This type of leveraging practice may involve an element of temporary price reduction, which under certain circumstances and market settings may be used in order to carry out predating strategies with the objective to drive rivals out of the market. The trap here is precisely the first leg of the functioning of bundling – voluntary price reductions. While some would like to call and to treat such price decreases as structural and sustainable efficiencies, they may actually be no more than strategic pricing behaviour, which can be made possible through cross-subsidisation and price discrimination.

The strong strategic element that they comprise is incompatible with the structural element, which is a necessary condition for consumer-benefiting efficiencies.

Furthermore, the undertakings proposed by the parties to address the concerns raised by product bundling indicate that the parties themselves did not believe in bundling as an efficiency-enhancing element. The parties proposed a set of behavioural undertakings by which they committed not to engage in bundled offers, unless there was specific demand from customers. Doesn't this confirm the idea that there were no real efficiencies stemming from bundling but only a strategic incentive to use bundled offers where they would help to reduce the competition, by winning platform exclusivity, for instance?

Is ex-ante control the only way to deal with leveraging of market power?

Let me now conclude with some remarks on a debate that antitrust authorities are more and more faced with in the assessment of conglomerate mergers. The question is articulated in the following form: “If leveraging practices are clear and easily detectable abuses of dominant position prohibited by antitrust laws (such as Article 82 of the EC Treaty), why should we

worry about them in merger cases?” In other words, why not wait until such practices have indeed occurred and challenge them later, using the appropriate ex-post antitrust laws?

Allow me to say that this is a false debate, which tends to put in doubt the whole legal system of ex-ante merger control policy.

While it is true that leveraging practices, such as product tying, are per se abuses which fall under the scope of Article 82 EC, isn't the same true for abusive price increases or any other abuse resulting from market dominance? Would this mean that ex-ante merger control should not bother to prevent the creation of dominance because, in any case, its subsequent abuse can be caught by the corrective and punishing mechanisms of specific ex-post legal provisions? The answer is certainly no.

Leveraging practices may have as a result the foreclosure of rivals, that is their gradual marginalisation or exit from the market or from some of its segments. In this respect, it is hardly conceivable that the punishment mechanism of ex-post instruments can do anything to prevent such market foreclosure. In other terms, the imposition of fines to the dominant merged firm, no matter how heavy they may be, cannot do much, if anything, to reinstate the competitive thrust and constraint of weakened or exiting rivals. The damage to competition will have already occurred and the legal system of prevention of the creation of market power, notably through an effective merger control policy, will have failed.

Ladies and Gentlemen

The aim of ex-ante merger control is to preserve competitive market structures and this has to be pursued with a view precisely to eliminate the need for a more or less intrusive regulation of market behaviour, with all its attendant evils.

Thank you for your attention.