Clearance of Near-Duopoly

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1. Introduction

In a notable phase one decision, the European Commission has unconditionally approved the creation of a near-duopoly in the supply of liquid packaging board ("LPB").[1] The acquisition by Korsnäs of Assi Domän Cartonboard ("AD Cartonboard") combined the second and third largest LPB suppliers in the EEA. The operation did not result in market leadership but it significantly increased concentration on an already heavily concentrated market. In fact, it created a near-duopoly with the two largest producers accounting for more than 90 per cent of the total supply in the EEA. The concentration did not only reduce the number of large suppliers in the EEA from three to two; it also enhanced the symmetry between the remaining producers and distorted the mirrored structure of the supply and demand side which the Commission had emphasised in its well-known clearance of the merger between Enso and Stora in 1998.[2] The Enso/Stora merger created a clear market leader in LPB and the case was cleared "on balance" at the end of the second phase. Not surprisingly, therefore, Korsnäs' acquisition of AD Cartonboard raised serious initial antitrust concerns. The Commission's decision in the *Korsnäs/AD Cartonboard* case is interesting because it sheds additional light on the non-co-ordinated effects test in oligopolistic markets and develops the concept of countervailing buyer power originating from the *Enso/Stora* case.

2. Background and key issues

Both Korsnäs and AD Cartonboard are producers of LPB which is sold to converters, mainly Tetra Pak, Combibloc and Elopak, which convert it into liquid packaging containers which are primarily used to pack milk and fruit juice. The production of LPB is, as paper and board production in general, characterised by high fixed costs. A high utilisation rate is therefore crucial for the producers' profitability. Pre-merger, the supply side was, in the EEA, characterised by one large producer (StoraEnso) and two smaller producers (Korsnäs and AD Cartonboard) whereas the demand side was characterised by one large customer (Tetra Pak) and two smaller customers (Elopak and Combibloc). Thus, the industry had a rather exceptional market structure. Korsnäs' acquisition of AD Cartonboard changed that structure. Post-merger, there were only two large suppliers facing one large and two smaller customers. Although market leadership was not created, the combination raised unilateral and co-ordinated effects concerns. An important issue was whether the remaining two suppliers would have the ability and incentive to increase their respective production in response to a price increase by the other. Another crucial question was whether the buyers would be deemed to have sufficient countervailing power also post-merger.

3. Market definition

3.1. Product market

The Commission concluded, in line with its *Enso/Stora* decision,[3] that LPB was distinct from non-liquid board but left open whether further segmentation within LPB was possible.[4] More importantly, however, the Commission recognised that there was a high degree of supply side substitutability between LPB and certain non-liquid board as far as *current* producers of LPB

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1 Case IV/M.4057 *Korsnäs/AD Cartonboard*, May 12, 2006. The author represented the seller, Sveaskog, and the target, AD Cartonboard. The buyer, Kinnevik/Korsnäs, was represented by Kent Karlsson, Linklaters, Stockholm. Andrea Coscelli (CRA) and Iestyn Williams (RBB Economics) provided economic advice to the buyer and seller respectively.

2 Case IV/M.1225 *Enso/Stora*, November 25, 1998. The author represented Stora in that case.

3 *Ibid.*, para.[41].

4 Case IV/M.4057 *Korsnäs/AD Cartonboard* at [9]–[22].

were concerned. Hence, the Commission accepted that LPB producers could use and in fact routinely use their machines to produce LPB and certain non-liquid consumer packaging boards or container boards.[5] Thus, the Commission recognised that LPB producers could increase LPB production by reducing production of non-liquid board at a very short notice and without incurring any significant costs. The Commission also accepted that LPB producers would have the incentive to substitute some lower margin non-LPB products for LPB products. By contrast, the Commission concluded that there was only a limited degree of supply side substitutability between LPB and non-liquid board as far as non-LPB producers were concerned. This *asymmetric* situation was probably a reason why the Commission considered supply side substitution in relation to the competitive assessment rather than in the product market definition.[6]

3.2. Geographic market

The Commission recognised that there were certain elements that pointed towards a worldwide market. The Commission particularly observed that transport costs were not in themselves prohibitive, that nearly one-third of LPB production was exported outside the EEA, that contracts with converters were concluded in a centralised manner with worldwide price schemes and volumes and that entry into the EEA could affect the EEA market by increasing imports or by decreasing exports by EEA producers. The Commission concluded, however, that it was premature to define a market wider than the EEA for LPB. The low level of imports (less than 5 per cent), regional differences in required product characteristics and the demand for reliability of supply and just-in-time deliveries were explicitly mentioned as factors confirming an EEA market.[7]

4. Non-co-ordinated effects

Since the combination did not result in market leadership, it was clear that it would not significantly impede competition by the creation or strengthening of a single dominant position.[8] Nevertheless, as pointed out in the Commission's Horizontal Merger Guidelines,[9] a reduction of competitive pressure in an oligopolistic market could result in a significant impediment to competition even where there is little likelihood of co-ordination. In *Korsnäs/AD Cartonboard*, the Commission, however, concluded that the acquisition would not, for several reasons, significantly impede competition as a result of non-co-ordinated effects.

First, it observed that Korsnäs and AD Cartonboard were not each other's closest competitors and that the merged entity would be able to compete more effectively with the market leader than each party separately. Secondly, it concluded that neither the merged entity nor StoraEnso would be able to profitably increase prices because the other would be likely to utilise its swing capacity in response. Thirdly, in particular Tetra Pak but also Elopak and Combibloc were deemed to enjoy countervailing buyer power also post-merger. Fourthly, competition from outside the EEA would, in two to three years, act as a growing constraint on both the merged entity's and StoraEnso's behaviour in the EEA. Fifthly, the combination was deemed likely to generate efficiencies which increased the likelihood of price competition. Each of these factors and the evidence taken into account by the Commission are discussed in more detail below.

4.1. Not each other's closest competitors

The Commission accepted the proposition that the transaction was, to a significant extent, a merger between two companies with complementary rather that overlapping product portfolios. Both parties produced LPB for the best selling one litre container but they did not compete in the low and high grammage segment. Korsnäs was active in the low grammage segment, while AD Cartonboard was active in the high grammage segment. Since StoraEnso supplied a full range, it was *regarded as the main competitor of each of the merging parties*. The Commission also recognised that the merged company would be able to *compete more effectively* with StoraEnso than Korsnäs and AD Cartonboard separately.[10]

5 Notably coated unbleached kraft board (CUK), and white top kraft liner (WTKL).
6 *Cf*. Commission's notice on market definition, paras 20–24.
7 Case IV/M.4057 *Korsnäs/AD Cartonboard* at [23]–[26].
8 Ibid., at [30]–[32].
9 "Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings" [2004] O.J. C31/5, para.25.
10 Case IV/M.4057 *Korsnäs/AD Cartonboard* at [34]–[36].

4.2. LPB suppliers not capacity constrained

The ability and incentive to increase supply if prices increased was, clearly, a crucial issue. As noted above, the Commission concluded that there was significant supply side substitutability as far as LPB producers were concerned. Thus, LPB producers could and actually did produce LPB and non-liquid board on the same board machines. The Commission noted that LPP suppliers could produce significant additional volumes of LPB at very short notice and without incurring any significant costs by utilising their swing capacity, i.e. by producing more LPB and less non-liquid board. Since, as observed by the Commission, producers often achieved higher margins with LPB than with non-liquid board, they should also have an incentive to utilise that swing capacity if LPB prices increased. In this regard, the Commission also investigated whether the suppliers faced any contractual restrictions from decreasing their production of some non-LPB products, but they did not identify any such switching barriers. On this basis, the Commission concluded that the merged entity and StoraEnso would, but for any tacit (or indeed explicit) co-ordination, have the ability and incentive to increase their respective production in response to a price increase by the other.[11]

4.3. Countervailing buyer power

It is well established, although in practice often difficult to prove, that buyers' bargaining strength could eliminate or at least alleviate non-co-ordinated or co-ordinated effects concerns.[12] Typically, the ability and incentive to (i) switch volumes to another supplier, (ii) integrate vertically or (iii) sponsor new entry or expansion by committing to place sufficiently large orders, all within a reasonable time frame, are key. Without such ability, it would be difficult to conclude that there is sufficient countervailing buyer power even if the buyer is a big company with large financial resources. Further, to offset potential adverse effects of a merger, it is generally not enough to establish that one or a particular segment of buyers are able to protect themselves from the exercise of market power. In addition, and this was particularly important in *Korsnäs/AD Cartonboard*, it is not sufficient that buyer power exists before the merger. It must also exist and remain effective after the merger. In the *Enso/Stora* case, the Commission had, considering the exceptional market structure with one large and two smaller suppliers facing one large and two smaller buyers,[13] concluded that the buyers, "on balance", had sufficient countervailing power.[14] Korsnäs' acquisition of AD Cartonboard changed this exceptional market structure and reduced the number of LPB suppliers within the EEA from three to two. The question was whether this was enough to tip the balance.

It did not. On the contrary, as the wording of the decision suggests, the Commission appears to have become even more convinced that Tetra Pak and the other customers enjoy countervailing buyer power.[15] In contrast to the *Enso/Stora* decision, there is no reference to any "mutual dependency" and the "on balance" conclusion is not found in the present decision. With respect to Tetra Pak, the Commission observed that all LPB suppliers were heavily dependent on it for a large share of their respective sales and profitability. In contrast, Tetra Pak was, but for any co-ordination, deemed capable of playing off the merged entity and StoraEnso against each other. In this regard, it was noted that Tetra Pak had shifted significant volumes from StoraEnso to Korsnäs and AD Cartonboard since the Enso/Stora merger. Thus, absent co-ordination, Tetra Pak should be able to resist any price increase by the merged entity or StoraEnso by reallocating volumes to the other party. In addition, and in line with the *Enso/Stora* decision, Tetra Pak would, according to the Commission, also be able to establish a new entrant in the EEA or support an increase in capacity of an existing player outside the EEA by committing to purchase volumes if it felt the need for it. With respect to Elopak and Combibloc, the Commission noted that even small supplies were crucial for LPB producers' profitability and it also found that their LPB procurement was large enough to establish a new

11 Ibid., at [37]–[42]. As a general remark, the fact that sufficient spare capacity could be found to undermine the profitability of a small (5–10 per cent) but permanent relative price increase (which should typically affect the scope of the relevant market, see e.g. para.17 of the Commission's notice on market definition) does not necessarily imply that it would be impossible to profitably raise prices by more than this post-merger (competitive effects analysis).

12 Horizontal Merger Guidelines, paras 64–67.

13 It is, from an economic point of view, difficult to see why the Commission stressed the one big-two smaller symmetry between sellers and buyers in the *Enso/Stora* case. As such, it does not tell very much, if anything, about the balance of power.

14 Case IV/M.1225 *Enso/Stora* at [97]. For a comment, see, e.g. Simon Baker and Andrea Lofaro, "Buyer Power and the Enso/stora Decision" [2000] E.C.L.R. 187.

15 Case IV/M.4057 *Korsnäs/AD Cartonboard* at [43]–[53].

entrant in the EEA or to support an increase in capacity outside the EEA. In contrast to the findings in the *Enso/Stora* case where the Commission concluded that switching supplier of LPB was difficult, the examples provided of volume switching after the *Enso/Stora* case, enabled the Commission to conclude that it was actually possible for LPB customers to shift significant volumes at short notice. Further, whereas in the *Enso/Stora* decision the Commission was concerned that Elopak and Combibloc could be disadvantaged in comparison with Tetra Pak, it now explicitly excluded the risk for discrimination against the smaller converters. Indeed, as the Commission concluded, such discriminatory policy would be counter-productive as it would affect the smaller customers' competitiveness and could ultimately leave the LPB suppliers with Tetra Pak as a monopsonistic buyer.

4.4. Growing competition from outside the EEA

Although apparently not decisive for the outcome, the Commission concluded that competition from outside the EEA will in two to three years exert a *growing constraint* on the merged entity and StoraEnso as regards their competitive behaviour in Europe.[16] As evidence, the Commission in particular relied upon the publicly announced plans for significant capacity increases in Brazil and China. Even though these additional volumes could be expected to be delivered mainly to South America and Asia, the Commission accepted that they were likely to have a *ripple effect* in the EEA. First, increased capacity and volumes outside the EEA would induce the merged entity and StoraEnso, which exported significant volumes out of the EEA, to reallocate volumes previously exported, thereby creating downward pricing pressure in the EEA market. Secondly, since converters typically agreed with their LPB suppliers on a single *ex*-mill price for deliveries to all their plants worldwide, additional capacities in, e.g. Brazil and China would exert a pricing constraint also on LPB deliveries in the EEA. Finally, the Commission did not exclude that new capacity outside the EEA could lead to increased imports into the EEA in the medium term.

4.5. Efficiencies

Substantial synergies were expected to arise as a result of the acquisition. The Commission was not, however, able to fully assess the efficiency claims in the first phase of the investigation. Nevertheless, the Commission found that the combination would allow the merged entity to increase overall production on the machines and, in the light of a new term sheet agreement with one of the customers and the general absence of concerns among customers, it was able to conclude that this category of efficiencies were likely to occur and be passed on to customers. These substantiated efficiencies were therefore deemed to strengthen the conclusion that the transaction would not impede competition as a result of non-co-ordinated effects.[17]

5. Co-ordinated effects

As noted above, the transaction created a near-duopoly in the EEA. Not surprisingly, therefore, the question of possible post-merger co-ordination between the two remaining suppliers was investigated in some detail.

The Commission found that the merged entity and StoraEnso would, for several reasons, face *difficulties in reaching terms of co-ordination*. First, while being enhanced by the merger, the symmetry between the two main suppliers would not be perfect post-merger. Both the merged entity and StoraEnso produced so-called white/brown LPB, whereas only StoraEnso produced white/white LPB. Thus, it would only be StoraEnso that would benefit from a migration from white/brown to white/white LPB in the event of a co-ordinated price increase in white/brown. Further, StoraEnso would still be much larger than the merged entity in terms of total and LPB production capacity. By operating five board machines, compared to the three operated by the merged entity, StoraEnso would also have significant advantage in terms of efficient allocation of production and thus cost structure. Secondly, LPB was not regarded a completely homogenous product. Thirdly, the limited number of customers and their buyer power would make it difficult to establish any customer sharing. Fourthly, the existence of long-term supply agreements (usually three years) staggered over time would make it difficult to establish co-ordination as it would take many years before co-ordination would be effective.

The Commission also found that *any co-ordination was unlikely to be sustainable over time*. First, both

16 Ibid., at [54]–[56].

17 *Ibid*., at [57]–[64]. An interesting issue which was not addressed in the decision is whether and to what extent the Commission would be prepared to accept pass-through of fixed cost savings: *cf*. Horizontal Merger Guidelines, para.80.

parties would have the ability (supply side substitution) and incentive (higher margins on LPB than on other products) to increase LPB production to the detriment of the other supplier. Thus, the merged entity and StoraEnso would have strong incentives to deviate. Further, co-ordination would be unstable because the buyers, which had strong countervailing power, would oppose rather than pass on any price increase.

Finally, the Commission found that *retaliation did not seem to constitute a credible threat* to a supplier which would deviate from any co-ordination. The existence of long-term contracts staggered over time implied that a supplier would be able to retaliate only several months or even years after the deviation occurred. In view of the foregoing, the Commission concluded that the transaction would not impede effective competition as a result of co-ordinated effects.[18]

6. Concluding remark

The decision to clear Korsnäs' acquisition of AD Cartonboard already in the first phase of the investigation may, at a first glance, appear somewhat brave, especially as the preceding combination of Enso and Stora was approved only after a full phase two investigation and "on balance" where the Commission "took note" of the commitments offered by the merging parties.[19] Obviously, the absence of negative customer reactions clearly facilitated the outcome of the present case. More importantly, however, market development since the *Enso/Stora* case provided strong support for a positive decision. As a practical matter, the *Korsnäs/AD Cartonboard* case confirms the willingness by the Commission to seriously consider a transaction in a pre-notification process. Thus, although not always the best option, it is often worthwhile for the parties to spend considerable time and effort in dealing with the Commission prior to the submission of a complete notification in complex cases. In substance, the decision reminds us that a 3 to 2 merger does not necessarily have to remove but could actually create a (more) credible source of supply and thereby enhance rather than weaken competition.

18 Case IV/M.4057 *Korsnäs/AD Cartonboard* at [66]–[80].

19 Thus, in *Enso/Stora*, the clearance decision was not conditional upon compliance with the commitments offered. This is unusual practice. *Cf.* para.12 and fn.13 of the Commission's remedies notice.