

COURT UPHOLDS COMMISSION'S *GE/HONEYWELL* MERGER DECISION

The Commission has won a Pyrrhic victory in the appeal against its prohibition of the 2001 *GE/Honeywell* merger. On 14 December 2005, the CFI upheld the Commission's reasoning on the horizontal effects of the merger, but rejected its controversial analysis of the vertical and conglomerate effects as being based on insufficient evidence

Background

In July 2001, the European Commission prohibited the proposed acquisition by General Electric Company (GE) of Honeywell. The reason given was that the transaction would create or strengthen a dominant position in a series of markets related to aircraft engines and avionics. The Commission based its decision not only on the horizontal overlap between the parties' products in certain markets, but also on conglomerate effects in others, ie. the merged entity's ability to bundle GE's engines and Honeywell's avionics and other products, and the vertical relationship between GE's engine manufacturing activities and GE Capital's aircraft financing and leasing activities (GECAS).

The Commission considered the following markets:

Product market	Theory of harm alleged
Large commercial aircraft engines	Strengthening of GE's dominant position as a result of the merged entity's ability to offer package deals of engines and avionics, and the vertical integration of GE's engine business with Honeywell's engine starter business
Large regional jet aircraft engines	Strengthening of GE's existing dominant position through the horizontal overlap between the two parties' products on existing platforms, and the ability to offer package deals in relation to future platforms.
Corporate jet engines	Creation of a dominant position through the horizontal overlap between the two parties' products, strengthening Honeywell's already leading position, the vertical integration with GECAS and the merged entity's ability to offer package deals.
Avionics and non-avionics products	Creation of a dominant position through the combination of Honeywell's already strong position in these markets with GE's financial strength and vertical integration, particularly with GECAS, and the packaged offering of avionics and engines. The merged entity would be able to price its packages in such a way that competitors who could not offer similar bundles would be foreclosed from the market.
Small marine gas turbines	Creation of a dominant position through the horizontal overlap of the parties' products, and the vertical integration of Honeywell with GECAS

The parties offered an initial package of structural and behavioural commitments in an unsuccessful attempt to address the Commission's concerns, and offered further last minute commitments, but too late to be considered by the Commission before the deadline for its decision.

The decision caused considerable controversy, and something of a rift between the US and EU antitrust authorities, with a number of US officials criticising the Commission's reliance on what they described as an outdated and discredited conglomerate effects theory. The Commission itself acknowledged in its decision that the economic analyses of the package offer effect of the merger had been the subject of controversy, but noted that it did not consider the reliance on any specific economic model necessary for its finding that the merged entity's ability to offer package deals would foreclose competitors.

Much has changed since July 2001. Following a series of defeats on merger appeals before the CFI, in which its analysis was subject to severe criticism, the Commission took a series of steps designed to improve the quality of its decision-making, including:

- the creation of the office of Chief Economist to DG Competition, to provide rigorous economic input and analysis;
- more transparent case-handling procedures, giving merging parties earlier access to arguments submitted by third parties, and regular "state of play" meetings with the case team; and
- the appointment of peer review or "devil's advocate" panels of senior officials not involved in the investigation, to challenge the case team's assessment of more complex cases.

The substantive test that the Commission applies has also been changed from the dominance test applied in 2001 to the "significant impediment to effective competition" (SIEC) test, which is virtually indistinguishable from the SLC test applied in the US and elsewhere. However, the application of the SIEC test in 2001 would probably not of itself have given rise to a different decision in *GE/Honeywell*.

A more significant reason for the likely different outcome of the case if decided today is simply that as a result of its defeats before the CFI, the Commission has learned to be cautious in applying some of the more speculative theories of economic harm in its merger decisions.

The judgment of the CFI

The appeal took more than 4 years to reach judgment – this was not one of the fast track merger appeal cases with limited arguments that have produced judgments within less than a year. In that time, the commercial deal had been abandoned, but the parties still wished to challenge the Commission's findings.

Standard of proof and the scope of the CFI's review

The CFI first considered the standard of proof and the scope of its review. It noted, following the judgment of the Court of Justice earlier this year in *Tetra Laval v. Commission*, that its review is limited to verifying the facts relied on and that there has been no manifest error of assessment. This does not prevent the courts from reviewing the Commission's legal classification of economic data. They must not only establish whether the evidence relied upon is factually accurate, reliable and consistent, but also whether that evidence contains all the information which must be taken into account in order to assess a complex situation and whether it is capable of substantiating the conclusions drawn from it.

Effective judicial review is all the more necessary when the Commission carries out a prospective review of developments that might occur as a result of a merger. Conglomerate effects may give rise to the creation or strengthening of a dominant position, but the chains of cause and effect in such cases may be dimly discernible, uncertain and difficult to establish. The quality of the evidence produced by the Commission in order to substantiate its arguments is particularly important.

At the heart of the Commission's analysis of the conglomerate effects was its prediction of certain behaviour, particularly the making of bundled offers, by the merged entity. It was therefore incumbent on the Commission to provide convincing evidence that that behaviour was likely. This meant that it was required to take into account not only the incentives to engage in such behaviour, but also countervailing factors, including the deterrent effect of the fact that such behaviour might be unlawful, for example where bundling might constitute an abuse of the merged entity's dominant position, contrary to Article 82 EC. However, the review of this possible deterrent effect need only be summary.

Vertical integration

In relation to large commercial aircraft engines, the CFI considered first the vertical integration between GE's engine business and Honeywell's engine starter business. It noted that the cost of a starter represents only approximately 0.2% of the cost of an engine. The Commission was concerned that the merged entity might disrupt supplies of starters to its competitors in the engine market, or increase prices. However, the CFI noted that if the Commission's analysis were correct, any such disruption would clearly amount to an abuse of GE's pre-merger dominance on the market for large commercial jet aircraft engines. Although it was not required to go as far as considering whether such behaviour would in fact be detected and punished, the Commission had failed to assess the possible deterrent effect of the application of Article 82 in this case. Moreover, even a 50% increase in the price of starters would cause only a 0.1% increase in the overall price of the engine, and such a large increase in the price of starters would similarly be abusive.

The Commission had therefore failed to establish to the required standard that the vertical integration of engines with starters would lead to a strengthening of GE's dominant position.

The CFI then turned to the key questions of bundling large commercial aircraft engines with avionics and other products, and of vertical integration with GECAS.

The GECAS effect

Although the Commission was correct to find that the activities of GECAS contributed to GE's pre-merger dominance in the market for large commercial aircraft engines, it did not necessarily follow that the merged entity would be able to transfer those practices to the markets for avionics and other products post-merger. There was no evidence of GE's intention to act in this way, and no analysis of whether the costs of doing so (in particular resulting from the need to offer incentives to airlines to overcome any preferences for other manufacturers' equipment) would outweigh the revenues.

Bundling

The CFI considered three types of bundling: pure bundling, where an undertaking ties purchases of products or services in a market in which it is dominant to purchases of products or services in a market in which it is not dominant, for commercial reasons, and without offering any financial incentive, technical bundling, where it imposes a tie for technical reasons, and mixed bundling, where the undertaking offers a package at a lower price than the sum of the prices of the package components.

A particular difficulty with allegations of bundling in this market was the fact that customers for engines and avionics and other products are not necessarily the same. In many cases, the engines will be selected by the airline, whereas avionics will be selected by the airframe manufacturer. Moreover, the choice of engine tends to be made at an earlier stage in the design process for a new aircraft type than the choice of avionics. These factors did not make bundling impossible, but they made it more difficult to put into practice.

In relation to pure bundling, the Commission made a number of manifest errors of assessment. It failed to provide any concrete examples of how the merged entity might tie the sale of engines to the sales of avionics. It also failed to consider the possible harmful effects for GE of attempting to compel airframe manufacturers to take its avionics and other products. Conversely, the CFI noted that a refusal to supply relatively inexpensive but vital avionics products unless the customer also purchased engines would be a form of commercial blackmail. The Commission had failed not only to establish that customers had lost all residual power to hold out against such a requirement, but also to consider the deterrent effect of the possible application of Article 82 to such extreme commercial conduct.

The Commission failed to provide any detailed analysis of the merged entity's ability to tie sales of avionics to sales of engines by technical means.

The CFI then considered the most important of the three concerns raised by the Commission, mixed bundling. The Commission had based its analysis on three lines of reasoning: that Honeywell had previously engaged in such practices, that the merged entity would have an economic incentive to engage in them and that bundling would be economically rational and therefore likely.

Firstly, the fact that Honeywell had previously engaged in bundling in relation to avionics products did not establish that the merged entity would do so in relation to engines and avionics.

Secondly, economic theory in this area was a matter of controversy. In the absence of a detailed economic analysis not merely of the economic conditions present on the relevant market, but also of the way in which the relevant economic theories applied to the particular circumstances of the case, the Commission had not succeeded in demonstrating, to the required standard or probability, that the merged entity would have engaged in mixed bundling after the merger.

Finally, the Commission had not provided sufficient evidence that the merged entity would have made the strategic decision to engage in mixed bundling. The fact that it could have done so did not mean that it would. There was no evidence of the likelihood of the hypothesis.

Horizontal overlaps

The CFI rejected the applicants' challenges based on the Commission's reasoning on the horizontal effects of the merger.

Moreover, it held that the Commission's errors in relation to its analysis of vertical and conglomerate effects had no effect on its analysis of horizontal effects, and therefore that the Commission was entitled to prohibit the merger.

Conclusion

It is clear that, although heavily criticized by a number of commentators, the conglomerate effects theory remains available to the Commission to use in appropriate cases. However, its use in future is likely to be limited. The CFI will expect to see particularly detailed and compelling evidence that a merged entity is likely to engage in bundling, and that it is likely to have the effects claimed.

Meanwhile, the differences between the Commission and the US authorities have largely been patched up. International co-operation and convergence are more important than they were in 2001.

Further information

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