Reflections on the European Commission's draft Merger Guidelines

A view on pivotality

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The draft Merger Guidelines formally introduce pivotality into the unilateral effects framework. What does this formalisation reveal, and what is left to be resolved in applications of this toolkit in future transactions? **Jorge** and **Roman** explain how pivotality has been applied in previous merger assessments by the Commission, examine the discussion of pivotality in the draft Guidelines, and suggest areas for further development.[1]

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Introduction

The European Commission's draft Merger Guidelines have formally introduced pivotality into the unilateral effects framework,[2] though the concept itself isn't new; it has featured in merger assessments in markets with capacity constraints for years.

Its formalisation in the draft Guidelines is therefore catching up with case practice rather than breaking new ground. The more interesting question is what the formalisation reveals and what it does not yet resolve. Pivotality has a clear economic meaning in a setting that few markets fully exhibit in practice. The draft Guidelines note several important limits to a mechanically-applied pivotality test, and this is a welcome acknowledgement. The harder methodological question, however, remains open: when pivotality is invoked outside its historic habitat, what is the underlying economic logic, and what evidentiary value should the analysis carry?

Pivotality in its classical form

Pivotality has a clear economic meaning in markets with three features: inelastic supply, inelastic demand, and a single market-clearing price that adjusts to balance the two at each instant. Wholesale electricity markets historically serve as the canonical example. A generator is *pivotal* during the times the total market demand cannot be met without its capacity. At those moments, it holds the structural position of a pivotal supplier setting the market price and can theoretically withhold capacity to its advantage. Pivotality, in this setting, is a direct measure of potential unilateral market power at a particular point in time.

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2 Draft Commission Communication, Guidelines on the assessment of mergers under Council Regulation (EC) No 139/2004 on the control of concentrations between undertakings ("**Draft Guidelines**"), paragraphs 148 – 152, accessible at: https://competition-policy.ec.europa.eu/mergers/review-merger-guidelines_en.

Unsurprisingly, pivotality was first adopted by the Commission to assess transactions in the electricity industry such as *EDF/British Energy* and *EDF/AEM/Edison*.[3] In those decisions, the pivotality framework sat comfortably on the underlying economics of the industry: at the relevant times, capacity was the binding constraint, demand could not adjust, and prices were set at the margin.

A similar logic appeared in cases that did not explicitly invoke pivotality but instead applied a closely related *Bertrand-Edgeworth-style framework*, in which firms compete based on prices subject to their capacity constraints. In this setting, capacity-constrained rivals supply up to their capacity levels and leave the residual demand for a less-constrained competitor.[4] In these cases, residual demand reflects the less-constrained firm's ability to exercise market power, similar to the concept of pivotality.

Applying pivotality outside of its natural habitat

Since its first implementation, the pivotality framework has been extended to cases where the relevant markets do not exhibit the same ideal characteristics as electricity markets. One notable example is *Novelis/Aleris*,[5] a transaction concerning aluminium body sheets (ABS) for the automotive industry. In this product market, prices are determined by bilateral contracts and tender processes over multi-year horizons, rather than by a uniform spot mechanism with market-clearing prices.[6] While demand may be inelastic for any individual tender due to short-term qualification lead times and finishing capacity constraints, both supply and demand become materially more elastic over a multi-year horizon. Automotive manufacturers can substitute steel at the next vehicle-platform design cycle, and rival suppliers have time to expand capacity.

Despite these differences in market characteristics from the traditional setting for a pivotality framework, the Commission used pivotality as a central element in its theory of harm.[7] It computed the share of demand that could not be met by rivals' available capacity and concluded that the merged entity would be pivotal for a substantial portion of the market demand. From this, the Commission inferred increased market power for the merging parties and the ability to raise prices.

The Commission's logic in applying pivotality to a market characterised by tenders was that a pivotal firm would have less incentive to bid aggressively for any given tender (despite not being pivotal for each particular tender), because some residual demand would still need to be filled by it at a later date.[8] Even if the pivotal firm did not win a specific tender, customers would eventually run out of viable alternative suppliers and be reliant on the pivotal firm. Accordingly, the pivotal firm's bidding behaviour today internalises the expected tender outcomes tomorrow.

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3 See e.g., Case M.5224 - EDF/British Energy and Case M.3728 – EDF/AEM/Edison. The Commission's assessment of pivotal capacity is also reflected in Case M.4180 – Gaz de France/Suez and Case M.5549 – EDF/Segebel, cited at footnote 231 of the Draft Guidelines.

4 See e.g., Case M.6471 — Outokumpu/Inoxum.

5 Case M.9076 — Novelis/Aleris.

6 Case M.9076 — Novelis/Aleris, paragraphs 46-80.

7 Case M.9076 — Novelis/Aleris, Section 8.3.6.

8 Case M.9076 — Novelis/Aleris, paragraphs 545-547. The Commission notes that it did not claim price effects on contracts already signed, and that its "*main concern is the outcome of the tenders that will take place in the next five years (as contracts continuously come to expiry and have to be re-negotiated)*." The relevant competitive interaction is therefore a forward-looking one across the stream of future tenders, not a snapshot of any individual tender.

The Commission's application of pivotality in *Novelis/Aleris*, therefore, introduced an important intertemporal intuition into a historically static pivotality framework, recognising that firms today take expected future market outcomes into account when competing.

The draft Guidelines: a welcome step in the right direction

The draft Guidelines' formalisation of pivotality reflects the case-practice journey and the lessons that have accumulated along the way. The Commission defines pivotality by reference to the share of demand that cannot be met without a firm's capacity and identifies three conditions that bear on the assessment.

First, the draft Guidelines explicitly acknowledge that the assessment "*may examine the change in the degree of pivotality as an indicator of the increase in market power caused by the merger*",[9] treating pivotality as a matter of degree rather than as a binary metric – in line with the Commission's decisional practice.[10]

Second, the draft Guidelines consider that an increase in pivotality is more likely to be problematic where margins and market shares are high, and where rivals' ability or incentive to respond to price increases via capacity expansions is low,[11] which implicitly acknowledges that an increase in pivotality alone does not automatically raise concerns. In particular, if rivals can credibly respond to a price increase, the pivotal position dissipates.

Third, the draft Guidelines also note that where the variable costs of the merging firms and their rivals are materially different, their capacity shares and pivotality levels may be less reliable indicators of competitive harm, which is in line with the Commission's approach in *Gaz de France/Suez* and *EDF/Segebel*.[12] This again acknowledges that a finding of (an increase in) pivotality is not the end of the story, and that a merger's impact depends on whether rivals possess low-cost spare capacity that can undercut a price increase.

These three limits push pivotality analysis in the right direction – towards an effects-based and dynamic framework rather than a mechanical and static test. They implicitly acknowledge that pivotality is not a 'knife-edge' test and cannot be the sole basis for a competitive assessment.

What remains open

Pivotality, properly applied, should help assess the central question of whether a firm has the *ability* and *incentive* to raise prices. Outside of inelastic spot markets with no dynamic considerations, answering this question requires rigorous engagement with how a market evolves over time in response to a hypothetical price increase. The pieces the draft Guidelines have put in place address parts of this, but three observations from the application of pivotality in practice remain under-developed.

***First*, on a static frame, pivotality is a *necessary* but *not* a *sufficient* condition for ability and incentive to raise prices.**

The three conditions noted in the draft Guidelines direct the Commission to consider the broader unilateral-effects toolkit alongside a pivotality finding, but they do not directly address the over-inclusiveness of the pivotality test itself. If a firm is non-pivotal, it cannot profitably raise prices

9 Draft Guidelines, paragraph 151, emphasis added.
10 E.g., Case M.9076 — Novelis/Aleris, paragraph 240(b) of Annex I to the Decision.
11 Draft Guidelines, paragraph 151.
12 See Case M.4180 — Gaz de France/Suez, paras 758-759, and Case M.5549 — EDF/Segebel, paragraph 60.

because all customers can switch to alternative suppliers. In this direction, the pivotality test is conclusive.

But the inference does not run in the other direction: for a price increase to be unprofitable, a pivotal firm does not need to lose its *entire* volume to rivals, which is what static pivotality measures. It only needs to lose *sufficient* volumes for the margin lost on those volumes to outweigh the margin gained on the volumes retained at the higher price.

***Second*, the draft Guidelines do not yet articulate the full dynamic framework required to establish whether a firm has the ability and incentive to raise prices.**

Static pivotality is merely a structural finding about the balance between demand and supply. Whether that structural finding translates into the ability and incentive to profitably raise prices is a conduct question that, in turn, depends on how the market is expected to respond. An appropriate application of pivotality, therefore, requires engaging with dynamic supply- and demand-side responses to the hypothetical price increase presupposed in a unilateral theory of harm.

If rivals can credibly increase their capacity (including expansion of supply from outside the relevant market, such as imports or substitute products) in response to a price increase and if demand is sufficiently elastic, a static pivotality analysis systematically overestimates the pivotal firm's ability and incentive to raise prices. Notably, even if a pivotality analysis is forward-looking in the sense that it is assessed based on forecast capacity and demand, it is not necessarily dynamic if the capacity and demand are forecast based on today's price and market conditions without accounting for the merger-specific price increase presupposed by the unilateral theory of harm.

***Third*, the assessment of change in the degree of pivotality contemplated by the draft Guidelines is itself under-articulated in two related respects.**

The *first* is degree of pivotality in absolute terms (not just in comparison to the counterfactual): outside the traditional settings such as electricity markets, pivotality can be sensitive to the underlying capacity and demand assumptions. Residual demand that is marginal in magnitude can flip to non-pivotality under modest deviations in rival capacity or demand.

The *second* is duration: whether a pivotal position is expected to be durable or transitional bears directly on the credibility of any inference of harm, and on the size and persistence of any plausible effects. For instance, using the Commission's *Novelis/Aleris* framework, if a firm is only transitionally pivotal and cannot be certain that it would eventually serve the residual demand, it might have no incentive to compete less aggressively for any given tender or order.

Whether each of these observations is engaged with rigorously in any given case will determine whether pivotality analysis adds disciplined insight or whether it ends up as a knife-edge label with no meaningful content. In this respect, the discipline that the draft Guidelines bring is meaningful and a welcome step in the right direction. The remaining work is to further articulate the framework, rather than to correct-course-of-direction: pivotality is an appropriate framework for competitive assessment in capacity-constrained industries, even outside the classic inelasticity-and-clearing-price setting, but only if the analysis rigorously engages with the dynamic effects.