MERGER ASSESSMENT GUIDELINES

Summary of submissions on the 14 April draft and the Authorities' response

1. Six formal responses were received to the call on 14 April 2010 for comments on the revised draft of the joint Office of Fair Trading (OFT)/Competition Commission (CC) Merger Assessment Guidelines (the Guidelines).[1] All responses are published on the OFT and CC websites.

2. The respondents all commended the changes the Authorities had made following the first public consultation one year earlier. They acknowledged several improvements, in particular that the Authorities had made the text more consistent with other guidance from the Authorities, had indicated where their approaches diverged, had underlined the importance of market definition and the role of supply-side substitution within it,[2] and had underlined the generally benign nature of non-horizontal mergers.

3. However, respondents considered that areas remained where further improvements could be made. These were mainly:

   - the definition of a substantial lessening of competition (SLC);
   - exiting firms;
   - aspects of market definition, in particular the 'two-market' approach, customer markets and the use of variable profit margins;
   - coordinated effects; and
   - non-horizontal mergers.

4. The following paragraphs aim to capture the main points raised in the six submissions. The summary does not record specific drafting suggestions, many of which the Authorities accepted and fed into the published version.

General

5. The IBA considered that several key areas of jurisdiction and procedure were not treated fully enough in either the Guidelines or the OFT's *Jurisdictional and Procedural guidance (OFT527)*. This was especially so in relation to the concept of a relevant merger situation. The ABA noted a 'guidance lacuna' in relation to material influence since the OFT has jurisdictional guidance in this area but the CC does not.

6. The IBA welcomed the inclusion of more case references but highlighted some notable gaps and some inconsistencies between different parts of the text; for example, the section on material influence contained few references to precedents. Charles Russell and Ashurst recommended that quotations from the BSkyB/ITV report or the subsequent CAT judgment should be added to the section on control.

[1] American Bar Association's (the ABA's) Section of Antitrust Law and Section of International Law, Ashurst LLP, Charles Russell LLP, Freshfields Bruckhaus Deringer LLP, International Bar Association Antitrust Committee (the IBA—reflecting the views of lawyers from eight firms and the US Department of Justice) and LECG.

[2] However, Ashurst continued to believe that the Authorities placed insufficient weight on it and might be blurring the distinction between supply-side substitutability and new entry (see paragraph 17).

7. Charles Russell pointed to another ‘lacuna’: while the Guidelines refer to judgements at the OFT on its duty to refer when the likelihood of an SLC is considered above or below 50 per cent, they are ‘silent’ as to the OFT’s powers if the likelihood of an SLC is evenly balanced (ie 50 per cent); they recommended the addition of a footnote to fill this lacuna.

8. **Supplementary notes** (‘Practice Notes’) on specific issues were widely welcomed. Ashurst suggested adding notes on evidence and information requirements to the two underway on retail mergers and surveys. The IBA emphasized that such notes should be issued promptly and be as authoritative as the Guidelines.

General issues: The Authorities’ response

Further case references have been added; in particular citations from the judgments of the Competition Appeal Tribunal (the CAT) in BSkyB v. the CC and the Secretary of State, and of the Court of Appeal in BSkyB and Virgin Media v. the CC and BERR.

The CC plans to produce procedural guidance to supplement the Guidelines.

An SLC

9. Respondents recognized the efforts the Authorities had made in response to the comments on the April 2009 draft Guidelines to differentiate between a lessening of competition and an SLC. ‘The attempt to describe what constitutes an SLC as distinct from a mere lessening of competition is to be welcomed’, wrote the IBA. The change of emphasis was widely noted between, in the April 2009 version, not normally finding ‘an expectation of adverse effects on consumers’ and the wording of the April 2010 consultation document:

> it is not an adverse effect on the outcomes of the process of competition (eg prices) that differentiates an SLC from a lessening of competition; it is an adverse effect on rivalry. Whether a reduction in rivalry results in an SLC will depend on the extent of the reduction.

10. Several respondents[3] saw little difference between the effect on rivalry and the effect on outcomes of the process of rivalry (notably on consumers) and requested clarification. How great, for example, does the adverse effect on rivalry have to be (Charles Russell)? And what impact will the change have on the Authorities’ analysis of a possible SLC (ABA)?

11. Freshfields and the IBA also noted that the proposed position on this issue was at variance with the EC, US, Australian and New Zealand approaches.

An SLC: The Authorities’ response

The paragraphs describing an SLC have been revised so as better to explain what the Authorities mean by a significant effect on rivalry. The revised text acknowledges explicitly that reduced levels of rivalry are to the likely detriment of customers, and that an SLC will be expected to lead to an adverse effect on customers. The revised text states that evidence on adverse effects will therefore play a key role in assessing mergers.

[3] Charles Russell and the ABA.

The counterfactual

12. While the ABA welcomed the greater 'transparency and clarity' of the current text, it argued that the 'Guidelines should expressly confirm that the counterfactual must be grounded in sufficient factual detail to serve as a reliable benchmark for comparison to the post merger market'.

13. The IBA commented that amendment of the section on the counterfactual ensured consistency with previous cases. However, it noted that no reference was included to the *Coors* case,[4] although the amended text was consistent with it.

Exiting firms

14. Several respondents welcomed the recognition in the revised Guidelines that firms might exit from the market for reasons other than failure. Freshfields sought confirmation that *both* the OFT and the CC took this view. The ABA and the IBA would like to see more examples of exit for reasons other than failure. The ABA and Freshfields considered that some clarification on certain issues would be beneficial. They queried whether the deletions (which Freshfields applauded) of 'inevitability' and 'substantially less anti-competitive' represented changes of policy since the release of the previous draft in April 2009. However, Freshfields noted that the latter phrase was still sometimes used in the draft.

15. While agreeing that a putatively failing firm's immediate financial prospects needed to be investigated through the available relevant documents, some respondents considered this approach inadequate. LECG said that 'the focus on such accounting measures should be secondary to the more critical determinants of long-term economic viability'. Ashurst wanted to see more case references so as to show 'how the Authorities have applied accounting and documentary evidence in practice'.

16. Some respondents would like to see more detail on the methodologies applied by the Authorities in determining the counterfactual and more examples, for example on 'the possible unwillingness of the alternative purchasers to pay the asking purchase price' and on assessing parallel transactions (LECG), and on how the counterfactual might be changed from the pre-merger situation to an acquisition by another purchaser (not yet a bidder) (Freshfields).

17. Freshfields (with the endorsement of the IBA) reiterated its concern that the Authorities' 'first past the post approach' on parallel transactions lacked clarity and encouraged 'spoiler tactics' by competitors.

[4] *Serviced Dispense Equipment Limited (SDEL)/Coors Brewers Limited (Coors)*, CC, March 2005.

The counterfactual: the Authorities' response

Text has been added to emphasize that the Authorities will not speculate about the counterfactual, and that the extent to which the counterfactual will be specified will be limited to what can be reasonably foreseen.

The Authorities confirm that both the OFT and the CC are of the view that firms may exit from the market for reasons other than failure. The Authorities have only rarely adopted a counterfactual based upon exit for reasons other than failure. Consequently, they consider it sufficient to recognize other possibilities for exit without speculating about other specific situations that are likely to arise extremely rarely.

In relation to the impact on sales of an exiting firm, the Authorities had not intended to suggest in the 14 April draft that their approach had changed from considering whether exit would be 'substantially less anti-competitive' to considering whether it would be 'substantially more competitive' and they have amended the text accordingly. The Authorities continue to believe that the term 'substantially less anti-competitive', although inelegant, is the correct legal standard and this terminology is now used consistently throughout the text. The OFT confirms that, when it is considering exiting firm scenarios, the 'inevitability' criterion remains the test it applies; this is confirmed in the text.

References have been added, as suggested in the responses, to give illustrations of situations where the Authorities have applied accounting and documentary evidence in practice.

The Authorities' position on 'first past the post' for the consideration of parallel transactions remains unchanged (see http://www.competition-commission.org.uk/about_us/our_organisation/workstreams/analysis/pdf/response_to_consultation.pdf).

Market definition

18. Respondents welcomed the Authorities' decision to 'reinstate the traditional role of market definition … in determining the competition constraints on merging parties' (LECG), although the ABA suggested a clear statement in the Guidelines that market definition is always an important tool of merger assessment at some point in the analysis since it focuses on the competitive alternatives available to customers and their economic significance.

19. However, to the extent that they all followed the argument (the IBA found the relevant paragraph—paragraph 4.52—'unclear' and Ashurst thought it did not 'appear to make sense'), several respondents considered that the 'two-market approach' risked introducing uncertainty and confusion, raising the question of which of them provided the more accurate description of the competitive arena. The ABA recommended thinking only in terms of defining the 'relevant market' and incorporating the 'smallest market principle' in the methods to define this market (as, the ABA noted, do the guidelines of all other jurisdictions). The ABA feared that the approach outlined in the draft would result in overly broad markets; this could be avoided by starting the SSNIP test by taking a single product and then proceeding iteratively using the smallest market principle, rather than starting with a collection of putative substitutes. (The ABA also offered a technical critique of other aspects of the treatment in the draft of the SSNIP test; the ABA questioned in this connection if the reference to 'at least one product', rather than a certain product or set of products, represented a change of policy.)

20. Ashurst was concerned that the re-stated reliance on a postulated 5 per cent price increase for a SSNIP test ('rather than the usual 5–10 per cent increase') might lead to markets being defined too narrowly, particularly where demand elasticity increased as prices rose. This would lead to 'artificially high 'headline' market shares'. Ashurst believed this would result too from the continuing reluctance of the Authorities to put sufficient weight on supply-side substitutability. Overall, defining markets too narrowly 'could subvert the basic legal position' that the burden of proof should lie on the Authorities, and it could lead to more findings of market dominance in Chapter II cases.

21. Four respondents (Freshfields, Ashurst, LECG and the IBA) took issue with the section on **customer markets**. They said that price discrimination was an important area that should be discussed but, as generally in the guidance from competition authorities elsewhere in the world, it should be picked up in discussing product market or geographic market definition.[5] They said that it was important to explain that price discrimination could only be applied (and a market be defined by customer groups) if firms could target separate customer groups to which to apply different prices and if customers could not defeat such a targeted SSNIP through arbitrage.

22. In the view of several respondents, **variable profit margins** were not reflective in many industries of a lack of intensity of competition, as the Guidelines suggested; the level of variable profit margins could reflect sellers' needs to obtain a return on fixed costs such as R&D and any inferences to be drawn from variable profit margins depended on the circumstances of the particular transaction and market. Freshfields emphasized that variable profit margins should be looked at for an industry as a whole, not just for the merging parties, and the Authorities should explain how they determined that variable profit margins of the merging companies were relatively high within the industry or sector concerned. ABA added that the inference that variable profit margins could be an indicator of pre-merger coordination was mistaken; 'markets in which high margins may be observed … may also be markets in which coordination (particularly tacit coordination) is less likely'.

23. Ashurst advocated adding or reinstating texts on **bidding markets, chains of substitution, R&D competition, secondary markets**, and expanding the section on **self-supply.**

[5] Freshfields noted the relevant exception of babies' glass bottles mentioned in the draft US Horizontal Merger Guidelines.

Market definition: the Authorities' response

The Authorities have emphasized that an analysis of the competitive alternatives available to customers will always be an important element of the assessment of a merger.

They have also clarified that there is just one relevant market within which the Authorities assess the effects of the merger on competition (although a merger could affect other markets).

The role of the hypothetical monopolist test is to check that the relevant market is not too narrow: the relevant market will always satisfy the hypothetical monopolist test.

The Authorities note that the present Guidelines represent a departure from their previous guidelines and from the approach of some other jurisdictions. Previously the Authorities' individual Guidelines stated that the relevant market would be no wider than the narrowest market needed to satisfy the hypothetical monopolist test. In practice, this restriction was not always applied in decisions taken under the Enterprise Act, and the Authorities now acknowledge that the relevant market—which will contain the significant competitive alternatives available to the customers of the merger firms—can be broader than the narrowest market.

The section on concentration measures, as now drafted, also refers to relevant markets. Although concentration measures can, in principle, be measured on any market, the Authorities will use market shares as a stand-alone indication of the intensity of competition only when they are calculated on the narrowest market worth monopolizing (which might be narrower than the relevant market).

The Authorities continue to take the view that the statement that they will normally use a SSNIP of 5 per cent, but that higher or lower figures may sometimes be postulated, provides sufficient flexibility for the application of the Hypothetical Monopolist Test.

The Authorities continue to believe that a separate discussion of customer markets is the clearest way of emphasizing the importance of price discrimination in market definition. However, they have revised the section on customer markets to explain more clearly the link between them and 'price discrimination markets' in product—and geographic—market definition.

New text has been added to clarify why the Authorities consider that variable profit margins are relevant to market definition. This stresses that the SSNIP test is more likely to be satisfied when variable profit margins are high because the value of sales recaptured by the hypothetical monopolist will be higher, making the SSNIP less costly. It also avoids directly linking high variable profit margins to statements about the competitiveness of the market: instead, it links variable profit margins to the price sensitivity of customers.

The section on other market characteristics (covering indirect competition, two-sided products, secondary products, self supply and asymmetric constraints) has been revised to make it clearer. A discussion of 'bidding markets' is in the section on supply-side factors, though the term is not used explicitly there. The Authorities do not accept the need for a discussion of chains of substitution; they consider that the proper application of the SSNIP test would prevent the market being widened on the basis of chains of substitution.

Coordinated effects

24. Freshfields and the IBA had concerns about the principle that suspected cartel actions might indicate that the conditions for coordination were met. Freshfields

would like to see clarification of how evidence of suspected cartel behaviour might be used in practice. The IBA recommended deletion of 'suspected' and noted that the US draft guidelines referred only to 'previous collusion or attempted collusion'. The ABA advised that evidence of past coordination should be discounted if it took place some time ago and in markets other than that of the merger under review.

25. Ashurst argued that it was incorrect to state that vertical mergers might create or strengthen coordinated effects; the 'existence of vertical integration can actually undermine the sustainability of collusion, by hindering market transparency in a number of ways'; conglomerate mergers might reduce the risk of coordinated outcomes.

26. Both the ABA and LECG challenged the statement (paragraph 4.121) that inelastic demand makes deviation less likely because demand will not change; 'by the same token', LECG wrote, 'it means punishment is less effective'. ABA wrote: 'inelastic demand makes collusion more sustainable and less sustainable'.

Coordinated effects: the Authorities' response

The Authorities recognize the practical and procedural difficulties that may arise if evidence of a suspected cartel forms part of the basis for a theory of harm based on coordinated effects. Nevertheless, the Authorities continue to believe that a cartel does not need to have been the subject of formal competition enforcement action for evidence about it to be relevant in the context of determining whether a merger will give rise to competition concerns based on coordinated effects. The Authorities accept that whether information about a proven or suspected cartel is relevant will depend on a significant number of different factors, including the identity of the market involved and how recently such activity is believed to have taken place.

Non-horizontal mergers

27. While welcoming that the Authorities now acknowledged that most horizontal mergers were benign, the ABA and the IBA considered that the treatment of total and partial foreclosure should be further refined. The ABA suggested that text be added to identify the market conditions that individually or collectively tended to heighten (or reduce) the Authorities' concern about possible tying and bundling arrangements.

Non-horizontal mergers: the Authorities' response

The Authorities have set out the general framework they will use when assessing non-horizontal mergers. This will be applied flexibly in light of the specific features of the case under review. Given the wide range of effects that tying and bundling can have, depending on the circumstances of the case, the Authorities do not consider it to be practicable or helpful to indicate conditions that will heighten or reduce the Authorities' concern.

Some other issues

28. *Entry and Expansion:* Freshfields noted that the revised text was less forthcoming than its predecessor about the likelihood that the Authorities will consider that entry 'within less than two years' could be timely, and suggested that some clarification of this apparent change in policy and of its likely impact would be helpful. LECG said that any assessment of entry should consider the product life-cycle (ie whether the market is expanding or contracting). They continued to argue that the Authorities

were not asking the right economic question in maintaining that they 'will evaluate whether entry is likely to take place at pre-merger prices'.

29. *Market share thresholds:* the IBA proposed that the Authorities should set a clear *de minimis* indicator or soft safe harbour for vertical mergers. LECG discerned that some parts of the text indicated that OFT thresholds continued in place (eg references to previous OFT decisions) and sought greater clarity here.

30. *Efficiencies*: there was little comment from respondents on efficiencies. The IBA would like to see more guidance on the types of data and studies that the Authorities would be likely to accept for analysis. The IBA also considered that a comment on dynamic efficiencies would be helpful.

Other issues: the Authorities' response

The Guidelines have been revised to emphasize that what matters for the entry decision is the likely post-entry price, and that it will often be appropriate to take the pre-merger price as an indication of what the post merger price would be.

The OFT has set out some guidelines it considers, as a Phase 1 body, might apply with regard to market share and concentration thresholds. It has provided thresholds, based on its past decisional practice, for unilateral effects in mergers in non-differentiated product markets, as well as in relation to the number of firms in retail mergers. For non-horizontal mergers, the OFT has stated that it may have regard to the thresholds set out in the European Commission's guidelines on the assessment of non-horizontal mergers.