

# **MERGER ASSESSMENT GUIDELINES**

**A joint publication of the Competition Commission  
and the Office of Fair Trading**

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## Part 1: Introduction

- 1.1 This publication forms part of the advice and information published by the Office of Fair Trading (OFT) and the Competition Commission (CC) under sections 106(1) and (3) respectively of the Enterprise Act 2002 (the Act). It is the first joint guidance document and supersedes the following OFT and CC guidelines:
- OFT publications: *Mergers—substantive assessment guidance* (OFT516), *Guidance note revising Mergers—substantive assessment guidance* (OFT516a) and *Revision to Mergers: Substantive Assessment Guidance—Exceptions to the duty to refer markets of insufficient importance* (OFT 516b);<sup>1</sup> and
  - CC publication: *Merger References: Competition Commission Guidelines, CC2*.
- 1.2 The publication explains the approach of the OFT when considering whether or not to refer a merger to the CC for further investigation and the approach of the CC when exploring more extensively the questions posed in merger references. It highlights the differences of emphasis, as well as the commonalities, between the two Authorities' approaches. The new guidelines comprise seven parts:
- *Part 1* presents the purposes of the publication and outlines the UK merger regime.
  - *Part 2* looks at the overarching questions the OFT and the CC must consider in conducting reviews of mergers.
  - *Part 3* defines what is meant by a 'relevant merger situation'.
  - *Part 4* defines a 'substantial lessening of competition' (SLC), outlines the concepts of 'theories of harm' and the 'counterfactual', and provides details on the criteria and methodology applied by the OFT and CC in considering the SLC test.
  - *Part 5* provides guidance on public interest and special public interest cases.
  - *Part 6* outlines the OFT and CC functions in relation to interim measures and remedies, with cross-references to the OFT's procedural and jurisdictional guidelines and the CC guidelines on *Merger Remedies, CC8*.
  - *Part 7* lists additional official guidance relevant to the UK merger regime.
- 1.3 Separate guidance published by the OFT and the CC from time to time contains additional information relevant to mergers, including on procedure, jurisdiction, the duty to refer mergers (and exceptions to that duty), interim measures and remedies.
- 1.4 The guidance applies with effect from the date of publication on the websites of the OFT or the CC.
- 1.5 In carrying out their functions, the OFT and the CC will have regard to this guidance and will generally apply the methodology and analysis summarized in it. But they will consider each merger with due regard to the particular circumstances of each case,

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<sup>1</sup>Chapters 7 and 8 (undertakings in lieu) of the OFT publications *Mergers—substantive assessment guidance* (OFT516) and *Revision to Mergers—substantive assessment guidance—Exception to the duty to refer: markets of insufficient importance* (OFT 516b) continue to apply prior to publication of the forthcoming OFT publication *Mergers—exceptions to the duty to refer and undertakings in lieu of reference*.

including the information available and the statutory time constraints applicable to the case.<sup>2</sup> Accordingly, while aiming to use a systematic approach to investigations, the organizations will apply the approach described in this guidance flexibly and may, if they consider it right to do so, depart from it.

- 1.6 This guidance reflects the views of the OFT and the CC at the time of publication. Markets, economic theory, legal thinking and best practice evolve. The guidelines may be revised from time to time to reflect such change and new or supplemental guidance may be published. The latest version is always that appearing on the OFT and CC websites.

### Note on terminology

- 1.7 Throughout this publication, the term ‘the Authorities’ is used when the guidelines apply to both the OFT and the CC; where that is not the case, the relevant body is specifically identified. All references in the document to statute, unless otherwise stated, relate to the Act. Situations leading to an SLC are described in the future tense throughout, regardless of whether or not the merger involved is completed or anticipated. The term ‘products’ is used to denote goods and/or services.

### The UK merger regime

- 1.8 The assessment of mergers in the UK is conducted as a two-phase process, giving distinct but interrelated roles to the OFT, the CC and sometimes the Secretary of State. Both anticipated and completed mergers are covered by the legislation.
- 1.9 At Phase 1 the OFT obtains and reviews information relating to merger situations.<sup>3</sup> UK merger control law does not require that a qualifying merger be notified to the OFT. However, companies can seek legal certainty by informing the OFT about a prospective merger in advance so as to obtain clearance (and the OFT encourages companies to contact it early in the merger process). The OFT has a duty to refer to the CC for further investigation any relevant merger situation where it believes that it is or may be the case that the merger has resulted or may be expected to result in an SLC.<sup>4</sup> Under the Water Industry Act,<sup>5</sup> the OFT has a duty to refer water mergers between two or more water enterprises whose turnovers are above defined thresholds (see [Water Merger References: Competition Commission Guidelines, CC9](#)). A decision by the OFT not to refer (a ‘clearance decision’) may be made conditionally or unconditionally.
- 1.10 The Secretary of State at the Department for Business, Enterprise and Regulatory Reform (BERR) has a role in certain merger decisions where there is a public interest or special public interest.<sup>6</sup> Where the Secretary of State has issued an intervention notice, the OFT (and Ofcom in the case of media mergers) must advise the Secretary of State on any mergers which might fall within the scope of the public interest or the special public interest provisions of the Act. The Secretary of State may refer public interest and special public interest cases to the CC (see [Part 5](#) on the public interest references and the subsequent role of the Secretary of State in such investigations).

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<sup>2</sup>For further information about the statutory deadlines applying in Phase I and Phase II, see OFT [Mergers—Jurisdictional and Procedural Guidance](#) and CC [General Advice and Information, CC4](#), respectively.

<sup>3</sup>Section 5 of the Act: the OFT is responsible for obtaining, compiling and keeping under review information about matters related to the carrying out of its functions, including merger review.

<sup>4</sup>Sections 22 and 33.

<sup>5</sup>Section 32 of the Water Industry Act 1991.

<sup>6</sup>See paragraphs 5.24 to 5.27.

1.11 At Phase 2, the CC investigates mergers that are referred to it, either by the OFT or, in public interest or special public interest cases, by the Secretary of State. It has no authority to investigate any merger unless it has been asked to do so by the OFT or the Secretary of State under a relevant statutory power, nor to dismiss a reference without considering the relevant questions. The CC determines the outcome of merger cases referred to it by the OFT. In the event that it finds that the merger will lead to an SLC, it has extensive remedy powers.

## The European dimension

1.12 Mergers that qualify as having a Community dimension under the EC Merger Regulation (ECMR)—typically those above a certain size—fall outside the scope of the Act’s jurisdiction. Instead they must be notified to the European Commission in Brussels, and, with some exceptions (see paragraph 1.13), the UK regime may not be applied to such mergers.<sup>7</sup>

1.13 A merger that falls under the ECMR may be considered, in whole or in part, under the Act in certain circumstances. This may be by way of transfer of the merger at the request of the merger firms<sup>8</sup> or of the OFT.<sup>9</sup> A merger falling under the ECMR may also be considered at the initiative of the Secretary of State to protect certain legitimate interests<sup>10</sup> (see paragraph 5.28).

1.14 In some circumstances, mergers that do not meet the thresholds for notification to the European Commission under the ECMR may be transferred to the European Commission for consideration at the request of the merger firms<sup>11</sup> or the OFT.<sup>12</sup> Accordingly, it is possible that a merger notified to the OFT under the Act could be referred to the European Commission. Further details on the relationship between the UK and European merger control systems are set out in the OFT’s [Mergers—Jurisdictional and Procedural Guidance](#) (Chapter 11).

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<sup>7</sup>Under Article 21(1), (2) and (3) of Council Regulation (EEC) No 139/2004/SC of 20 January 2004 (the ECMR), the European Commission shall have the sole jurisdiction over, and no member state shall apply its national legislation on competition to, any concentration that has a Community dimension. The OFT fulfils several functions as the UK’s competent authority under the ECMR. This includes liaison with the European Commission on the assessment and determination of cases notified to the European Commission.

<sup>8</sup>Article 4(4) of the ECMR.

<sup>9</sup>Article 9 of the ECMR.

<sup>10</sup>Article 296 EC Treaty and Article 21(4) of the ECMR and section 67 of the Act.

<sup>11</sup>Article 4(5) of the ECMR.

<sup>12</sup>Article 22 of the ECMR.

## Part 2: Merger review by the OFT and the CC

### The overarching questions

2.1 In assessing a merger, the Authorities must ask themselves two overarching questions: (1) whether a relevant merger situation has been created (or, for anticipated mergers, will be created) and, if so, (2) whether or not this situation will lead to an SLC. This Part of the guidelines describes both the similarities and the differences between the ways the OFT, at Phase 1, and the CC, at Phase 2, approach these questions.

### Phase 1

#### ***OFT duty to refer mergers to the CC***

2.2 The OFT has a duty to refer completed and anticipated mergers to the CC for investigation if it believes that it is or may be the case that:

- a relevant merger situation has been created, or arrangements are in progress or contemplation which, if carried into effect, will result in the creation of a relevant merger situation; and
- the creation of that situation has resulted, or may be expected to result, in a substantial lessening of competition within a market or markets in the UK for goods and services (SLC). The OFT is not required to consider its SLC test if it forms a reasonable belief that no relevant merger situation exists or may be expected to exist.

2.3 In considering whether to refer a merger to the CC, the OFT must form a reasonable belief, objectively justified by relevant facts, as to whether or not it is or may be the case that the merger has resulted, or may be expected to result, in an SLC. If the OFT believes that no SLC is likely to arise, it will grant an unconditional clearance.

2.4 The OFT must refer to the CC when it believes that the merger is more likely than not to result in an SLC. The Act also contemplates reference at lower ranges of probability. If the OFT believes that the relevant likelihood is greater than fanciful but below 50 per cent, it has a wide margin of evaluation in exercising its judgement. In such cases, it has the duty to refer when it believes there is a realistic prospect that the merger will result in an SLC.<sup>13</sup>

2.5 The realistic prospect threshold is intentionally a lower and more cautious threshold for an SLC finding than that applied by the CC after more extensive investigation (see paragraph 2.10). Two key factors will affect the OFT's judgement on whether there is a realistic prospect of an SLC: first, the evidence available on material points of the OFT's analysis; and second, in exercising its margin of evaluation, the potential adverse impact on consumer welfare (downside risk or 'error cost') of an incorrect decision not to refer. In cases where the OFT believes that the relevant likelihood is greater than fanciful but below 50 per cent, all else being equal, the less robust the evidence in favour of clearance, and the greater the cost of error of

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<sup>13</sup>The 'realistic prospect' formulation is a shorthand that captures more complex statutory language, clarified by the Court of Appeal in its judgment dated 19 February 2004 in *IBA Health Limited v OFT* [2004] EWCA Civ 142. The Act's wording provides that the OFT must refer when it believes it 'is or may be the case that ... it may be expected that' the merger will result in a substantial lessening of competition (section 33).

reaching the wrong decision, the more likely it is that the OFT will conclude that the test for reference is met.

2.6 The OFT's duty to refer is also subject to the application of three discretionary exceptions.<sup>14</sup> The OFT may decide not to refer if it believes that:

(a) the market(s) concerned is (are) not of sufficient importance to justify the making of the reference (the 'de minimis' exception);

(b) any relevant customer benefits outweigh the SLC; and

(c) in the case of an anticipated merger, the arrangements concerned are not sufficiently far advanced, or are not sufficiently likely to proceed, to justify a reference.

2.7 By precluding a CC reference, application of the first two of the above three provisions has the same effect as an unconditional clearance of the merger.

2.8 In addition, a reference cannot be made where the OFT is considering whether to accept undertakings in lieu of making a reference.<sup>15</sup> For further information about the duty to refer and the discretion of the OFT, including the consideration of relevant customer benefits, see the forthcoming OFT publication *Mergers—exceptions to the duty to refer and undertakings in lieu of reference*.

## Phase 2

### **Questions for the CC**

2.9 The CC has first to consider the two questions addressed by the OFT,<sup>16</sup> ie:

- whether a relevant merger situation has been created (or for anticipated mergers, is likely to be created); and
- whether the creation of that situation has resulted, or may be expected to result, in an SLC within any market or markets in the UK for goods or services. The CC is not required to consider its SLC test if it forms a reasonable belief that no relevant merger situation exists or may be expected to exist.

2.10 In answering the two questions and after a more extensive investigation, the CC is required to apply a higher standard of probability than is required of the OFT (see paragraphs 2.4 and 2.5). The CC must consider that a merger 'has resulted, or may be expected to result' in an SLC; it will apply a 'balance of probabilities standard' to its analysis, ie it addresses the question: is it more likely than not that an SLC will result?

2.11 The CC is not required to consider the second of the questions (ie the SLC) if it has decided that no relevant merger situation has been created or that no arrangements are in progress or contemplation which, if carried into effect, will result in the creation of a relevant merger situation. If the CC decides that there is an anti-competitive

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<sup>14</sup>Sections 22(2) and 33(2).

<sup>15</sup>Sections 22(3)(b) and 33(3)(b) in relation to the acceptance of undertakings under section 73(2).

<sup>16</sup>Section 35(1) for completed mergers and section 36(1) for anticipated mergers.

outcome<sup>17</sup>—that is, that an SLC has been, or will be, created—it must then consider the appropriateness of remedies.

2.12 In its consideration of remedies, the CC must decide three questions:<sup>18</sup>

- (a) whether action should be taken by the CC for the purpose of remedying, mitigating or preventing the SLC concerned or any adverse effect which has resulted from, or may be expected to result from, the SLC;
- (b) whether the CC should recommend the taking of action by others for the purpose of remedying, mitigating or preventing the SLC concerned or any adverse effect which has resulted from, or may be expected to result from, the SLC; and
- (c) in either case, if action should be taken, what action should be taken and what is to be remedied, mitigated or prevented.

Further information on CC remedies is set out in [Part 6](#) of these guidelines and in [Merger Remedies: Competition Commission Guidelines, CC8](#).

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<sup>17</sup>Defined in section 35(2).

<sup>18</sup>Sections 22 and 33.

## Part 3: The relevant merger situation

- 3.1 The Act applies to a ‘relevant merger situation’, ie a merger that meets one of the jurisdictional thresholds, and covers several kinds of transactions and arrangements. A company that buys or proposes to buy a majority shareholding in another company is the most obvious example. However, acquisitions of lesser shareholdings may also give rise to a relevant merger situation, as might the transfer or pooling of assets or the creation of a joint venture. This Part of the Guidelines sets out guidance on what constitutes a relevant merger situation. It is arranged in five sections:
- Section 1 lays out the criteria for determining whether or not a relevant merger situation has been created.
  - Section 2 deals with the factors considered in determining if an enterprise has ceased to be distinct.
  - Section 3 sets out the time periods for the investigation of mergers.
  - Section 4 discusses the turnover test.
  - Section 5 discusses the share of supply test.
- 3.2 In the Authorities’ experience, issues relating to whether a relevant merger situation has arisen are more likely to be considered when a transaction is being reviewed by the OFT. The OFT has therefore issued its own guidance providing further detail on what it will consider to be a relevant merger situation: the OFT’s [Mergers—jurisdictional and procedural guidance](#).<sup>19</sup> (As noted in paragraphs 1.12 to 1.14, as a general rule, mergers that fall under the scope of the ECMR are excluded from review under the Act.)

### Section 1: Criteria for a relevant merger situation

- 3.3 A merger must meet all three of the following criteria to constitute a relevant merger situation for the purposes of the Act:
- two or more enterprises must cease to be distinct, or there must be arrangements in progress or in contemplation which, if carried into effect, will lead to enterprises ceasing to be distinct; and
  - either:
    - the value of UK turnover of the enterprise which is being acquired exceeds £70 million (known as ‘the turnover test’—see paragraphs 3.27 and 3.28); or
    - the enterprises which cease to be distinct supply or acquire goods or services of any description and, as a result of the merger, together supply or acquire at least 25 per cent of all those particular goods or services supplied in the UK or in a substantial part of it. To qualify, the merger must result in an increment to the share of supply or consumption and the resulting share must be at least 25 per cent. In practice, therefore, the share of supply test can only be met where the enterprises concerned supply or acquire goods or services of a

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<sup>19</sup>See Chapter 3 of the OFT [Mergers—jurisdictional and procedural guidance](#).

similar kind (known as ‘the share of supply test’—see paragraphs 3.29 to 3.34); and

- either the merger must:
  - not yet have taken place; or
  - have taken place not more than four months before the reference is made unless the merger took place without having been made public and without the OFT being informed (in which case the four-month period starts from the earlier of the time the merger was made public or the time the OFT was told about it).<sup>20</sup>

3.4 It is implicit in these criteria that at least one of the enterprises must be active within the UK. Where the turnover test is met, this will by definition be because the target generates turnover from sales to UK customers. For the share of supply test, both of the enterprises ceasing to be distinct must be active in supplying or acquiring goods or services within the UK or a substantial part of the UK. These principles apply equally to non-UK companies that sell to (or acquire from) UK customers or suppliers.

## Section 2: Enterprises ceasing to be distinct

3.5 Two enterprises will ‘cease to be distinct’ if they are brought under common ownership or control.

### **Enterprises**

3.6 The term ‘enterprise’ is defined in section 129 of the Act as the activities, or part of the activities, of a business. The enterprise in question need not therefore be a separate legal entity. The definition in the Act states that the activities in question should be carried out for ‘gain or reward’. However, there is no requirement that the transferred activities should be currently profitable, or generating a dividend for shareholders, and transferred activities conducted on a not-for-profit basis are caught by the definition.

3.7 In making a judgement as to whether or not the activities of a business, or part of a business, constitute an enterprise under the Act, the Authorities will have regard to the substance of the arrangement under consideration, rather than merely its legal form. As a result, it may not be the case that one single factor will prove determinative in reaching a conclusion.

3.8 An ‘enterprise’ may comprise any number of components, most commonly including the assets and records needed to carry on the business, together with the benefit of existing contracts and/or goodwill. In some cases, the transfer of physical assets alone may be sufficient to constitute an enterprise, for example where the facilities or site transferred enable a particular business activity to be continued. Intangible assets such as intellectual property rights are unlikely, on their own, to constitute an ‘enterprise’ unless it is possible to identify turnover directly related to the transferred intangible assets that will also transfer to the buyer. The business acquired may no

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<sup>20</sup>See also paragraphs 3.24 to 3.26. The OFT also has the power to suspend the statutory deadline in certain circumstances where the parties have not provided satisfactory responses to OFT information requests (see OFT [Mergers—jurisdictional and procedural guidance](#), section on Information Gathering Powers).

longer be trading but this does not in itself prevent the business from being an enterprise for the purposes of the Act.

### **Control**

- 3.9 'Control' is not limited to the acquisition of outright voting control but includes situations falling short of outright control. Section 26 of the Act distinguishes three levels of interest referred to as 'control' (in ascending order):
- Company A, the acquirer, may acquire the ability materially to influence the policy of Company B, the target (known as 'material influence');
  - Company A may acquire the ability to control the policy of Company B (known as 'de facto' control); and
  - Company A may acquire a controlling interest in Company B (known as 'de jure', or 'legal' control).
- 3.10 Section 26(3) of the Act provides the Authorities with a discretion (rather than an obligation) to treat material influence and de facto control as equivalent to legal control.
- 3.11 The Act also contains provisions to deal with situations in which a company acquires de facto control or a controlling interest by stages or where 'associated persons' might act together to gain control.

### **Material influence**

- 3.12 The ability to exercise material influence is the lowest level of control that may give rise to a relevant merger situation. In assessing material influence in the context of the Act, the Authorities will conduct a case-by-case analysis, focusing on the overall relationship between the acquirer and the target and on the acquirer's ability materially to influence policy relevant to the behaviour of the target entity in the marketplace. The policy of the target includes the strategic direction of a company and its ability to define and achieve its commercial objectives.
- 3.13 The acquirer's ability to influence the target's policy can arise through the exercise of votes at shareholders' meetings, together with any additional supporting factors that might suggest that the acquiring party exercises an influence disproportionate to its shareholding. Material influence may also arise as a result of the ability to influence the board of the target and/or through other arrangements.
- 3.14 In considering whether material influence may be present by virtue of a shareholding in a particular case, the Authorities will consider not only the ownership of the shareholding but also whether, as a matter of practice, the acquiring party is able to exert influence. Other factors that may be relevant to an assessment of a particular shareholding include:
- the distribution and holders of the remaining shares, in particular whether the acquiring entity's shareholding makes it the largest shareholder;
  - patterns of attendance and voting at recent shareholders' meetings based on recent shareholder returns, and in particular whether voter attendance is such that the shareholding under consideration would be able in practice to block special resolutions;

- the existence of any special voting or veto rights attached to the shareholding under consideration;
  - the status and expertise of the acquirer and its corresponding influence with other shareholders; and
  - any other special provisions in the constitution of the company conferring an ability materially to influence policy.
- 3.15 In addition to the ability materially to influence policy through the voting of shares, the Authorities' determination may also, or alternatively, turn on whether the acquirer is able materially to influence the policy of the target entity through board representation. Indeed, it is possible that board representation alone could, in certain circumstances, confer material influence.
- 3.16 The Authorities may also consider whether any other factors, such as agreements with the company, enable the acquirer materially to influence policy. These might include the provision of consultancy services to the target or might, in certain circumstances, include agreements between firms that one will cease production and source all its requirements from the other. Financial arrangements may in certain circumstances confer material influence where the conditions are such that one party becomes so dependent on the other that the latter gains material influence over the company's commercial policy.

### ***De facto control***

- 3.17 It is possible that merger arrangements give rise to a position of 'de facto' control when an entity is clearly the controller of a company, notwithstanding that it holds a 50 per cent voting stake or less in the target company (ie it does not have a controlling interest). This is likely to include situations where the acquirer has control over more than half of the votes cast at a shareholders' meeting. It might also involve situations where an investor's industry expertise leads to its advice being followed to a greater extent than its shareholding would seem to warrant (although this factor could equally be relevant to a finding of material influence).

### ***A controlling interest***

- 3.18 A 'controlling interest' generally means a shareholding of more than 50 per cent of the voting rights in a company. Only one shareholder can have a controlling interest, but it is not uncommon for a company to be subject to the control (in the wider sense described above) of two or more major shareholders at the same time—in a joint venture, for instance. Thus, as explained in the preceding paragraphs, a significant minority shareholder may be seen as being able materially to influence a company's policy even though someone else owns a controlling interest.

### ***Acquiring control by stages***

- 3.19 Under section 26(4) of the Act, should a shareholding (and/or a level of board representation) that confers the ability materially to influence a company's policy increase to a level that amounts to 'de facto' control or a controlling interest, that further acquisition will produce a new relevant merger situation. The same applies to a move from 'de facto' control to a controlling interest.
- 3.20 In principle, therefore, if Company A acquires Company B in stages, this could give rise to three separate mergers: first, as Company A moves to material influence; then

to 'de facto' control; and, finally, to a controlling interest. But further acquisitions of a company's shares by a person who already owns a controlling interest do not give rise to a new merger situation.

- 3.21 Where a person acquires control of an enterprise (in any of the three senses described above) during a series of transactions within a single two-year period, section 29 of the Act allows the transactions to be considered as having occurred or occurring simultaneously on the date of the last transaction and thus to be treated as a single reference. In giving effect to this provision, the Authorities may take into account transactions in contemplation.

### ***Associated persons***

- 3.22 For the purposes of considering whether an enterprise has ceased to be distinct, section 127 of the Act allows the Authorities to consider whether several persons acquiring an enterprise are 'associated persons' and thus should be viewed as acting together.
- 3.23 This situation will most commonly arise where the acquiring persons are related or have a signed agreement to act jointly to make an acquisition, although the Act does not require that each of the acquiring parties should individually have control over the acquired entity for them all to be regarded as being associated persons. It is also possible that separate entities may be considered to be 'associated persons' where they appear to have common incentives to act together for the purpose of gaining control over the acquired enterprise.

### **Section 3: Time period for investigating mergers**

- 3.24 For the OFT to be able to refer a merger to the CC, either:
- the merger must not yet have taken place; or
  - under section 24 of the Act, the completed merger must have taken place not more than four months before the reference is made (see paragraph 3.3).
- 3.25 In cases where the OFT is not informed directly of material facts about the merger, the four-month period is deemed to have commenced when material facts are 'made public', ie when they are 'so publicised as to be generally known or readily ascertainable'. The OFT also has the power to 'stop the clock' in certain circumstances (see footnote to paragraph 3.34).
- 3.26 Section 27(5) allows the Authorities to treat successive events within a period of two years between the same parties (or in consequence of the same arrangements or transaction) as occurring simultaneously on the date of the latest event (see paragraph 3.22). The Authorities have discretion in whether to apply this section.

### **Section 4: The turnover test**

- 3.27 The 'turnover test' is satisfied where the annual value of the UK turnover of the enterprise being acquired exceeds £70 million. In essence, the turnover in question is that achieved by the target, or targets, in the UK.
- 3.28 In general, the turnover test applies to the turnover of the acquired enterprise that was generated by the sale of goods or services to customers within the UK in the

business year preceding the date of completion of the merger or, if the merger has not yet taken place, the date of the reference to the CC.

## Section 5: The share of supply test

- 3.29 Under section 23 of the Act, the 'share of supply test' is satisfied if the merger enterprises:
- either supply or acquire goods or services of a particular description; and
  - will, as a result of the merger, collectively supply or acquire 25 per cent or more of those goods or services, in the UK as a whole or in a substantial part of it, provided that the merger results in an increment to that share.
- 3.30 The increase in the share of supply must result from the enterprises ceasing to be distinct. In the case of an acquisition, the share of supply is based on the activities of the acquirer and the target company. In joint venture situations, the share of supply is calculated by reference to the activities of the joint venture, although it will include shares of the joint venture parents where they continue to undertake the same activities as the joint venture.
- 3.31 The Act expressly allows the Authorities a wide discretion in describing the relevant goods or services, requiring only that, in relation to that description, the parties' share of supply or acquisition is 25 per cent or more. The test is distinct from a market share test (paragraphs 4.84 to 4.93), and goods and services to which the jurisdictional test is applied need not amount to a relevant economic market. In addition, the Authorities may have regard to any reasonable description of a set of goods or services to determine whether the share of supply test is met—the value, cost, price, quantity, capacity, number of workers employed or any other criterion may be used to determine whether the 25 per cent threshold is reached.

### **Substantial part of the UK**

- 3.32 The share of supply test may be applied to the UK as a whole or to a substantial part of it. There is no statutory definition of 'a substantial part'. The House of Lords ruled in the context of similar provisions in the Fair Trading Act 1973 (FTA) that, while there can be no fixed definition, the area or areas considered must be of such size, character and importance as to make it worth consideration for the purposes of merger control.<sup>21</sup> The Authorities will take into account: the size, population, social, political, economic, financial and geographic significance of the specified area or areas, and whether it is (or they are) special or significant in some way.
- 3.33 For the application of the share of supply test, there is no need for the substantial part of the UK to constitute an undivided geographic area. The economic significance of a merger, in terms of an SLC, does not necessarily depend on whether several localities are contiguous or separated.

### **Supply of goods or services in the UK**

- 3.34 The share of supply test requires that the merger would result in the creation or enhancement of at least a 25 per cent share of supply or acquisition of goods or

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<sup>21</sup>See *Regina v Monopolies and Mergers Commission and another ex parte South Yorkshire Transport Limited* [1993] 1 WLR 23.

services either in the UK or in a substantial part of the UK. Services or goods are generally deemed to be supplied in the UK where they are provided to customers who are located in the UK.<sup>22</sup>

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<sup>22</sup>See, for example, *Thermo Electron Manufacturing Limited/GV Instruments Limited*, CC, May 2007; and *Anticipated merger between NYSE Group Inc and Euronext NV*, OFT, 9 October 2006.

## Part 4: A substantial lessening of competition

- 4.1 This Part of the guidelines is set out in three sections. Section A describes what is meant by an SLC. Section B outlines the concepts of ‘theories of harm’ and the counterfactual, and Section C describes in detail the criteria and methodologies the Authorities use when applying the SLC test.
- 4.2 There are broadly three categories of mergers discussed in these sections:
- *Horizontal mergers*: mergers between firms that operate in the same economic market.
  - *Vertical mergers*: mergers between firms that operate at different levels of the supply chain of an industry.
  - *Conglomerate mergers*: mergers between firms in different markets.

### Section A: What is an ‘SLC’?

- 4.3 ‘SLC’ is not defined in the Act. The following paragraphs set out what the Authorities mean by this and related terms.
- 4.4 Competition is viewed by the Authorities as a process of rivalry between suppliers (ie firms) seeking to win customers’ business over time by offering them a better deal. Rivalry may take various forms. Firms may seek to undercut each other on price, produce more output, outperform each other on reducing costs, improving quality, enhancing productivity or increasing innovation to create new or improved products or markets. For customers, rivalry can therefore have many beneficial effects, for instance by driving down prices, by increasing output and by improving quality and variety.
- 4.5 Any merger will be considered by the Authorities in terms of how it affects rivalry over time. A merger which substantially lessens competition over time—giving rise to an SLC—will reduce the beneficial effects of rivalry, creating an ‘adverse effect’ for consumers. The Authorities would not normally find an SLC without an expectation of adverse effects for consumers.
- 4.6 In some markets, the direct customers of the merger firms may not be end- or final consumers.<sup>23</sup> In practice, the Authorities treat mergers in such ‘upstream’ markets in the same way as those in ‘downstream’ markets which serve end-consumers.<sup>24</sup> An SLC that harms upstream customers will be presumed to lead to detriment to final consumers as well, in the short or longer term. The Authorities do not consider it necessary to trace the path of adverse effects down the supply chain.
- 4.7 By contrast, where the merger is expected to result in adverse effects on businesses that are not customers of the merger parties, the Authorities will examine carefully whether harm to final consumers can be expected to result (directly or indirectly) from the merger. This could arise, for example, in mergers of vertically-integrated firms, where there would be downstream competitors of, and upstream suppliers to, the merger firms.

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<sup>23</sup>The Act defines ‘customers’ and ‘consumers’ in section 129(1). As well as referring to end-consumers, the Authorities use the term ‘customers’ to encompass direct customers of the merger firm who are not necessarily end-consumers.

<sup>24</sup>An ‘upstream firm’ supplies its products higher up the supply chain to ‘downstream firms’ further down the chain, which use the products as an input.

## Section B: The SLC test: ‘theories of harm’ and the counterfactual

- 4.8 At the outset of the respective phases of an inquiry, the Authorities each set out the one or more ‘theories of harm’ that they use as the framework for substantive merger analysis. These may be revised as the inquiry continues.
- 4.9 The theories of harm trace the logical steps between the merger, the loss of rivalry and expected harm to customers, compared with the situation likely to arise if the merger did not take place (known as the ‘counterfactual’). Identifying the counterfactual is central to the Authorities’ overall assessment of a merger since the core concept of an SLC is the lessening of competition caused by the merger when compared with what would have happened had the merger not taken place.

### **Theories of harm**

- 4.10 In formulating theories of harm, the Authorities may first set out those aspects of firms’ offers to consumers over which the firms compete and which could worsen as a result of the merger. A firm’s competitive offer to consumers may take several forms: in addition to price, non-price aspects might include the quantity sold, service quality, product range, product quality, geographical location, productive capacity and innovation. The ability of firms to adjust these aspects, and also the time within which they can do so, will depend upon the market concerned.
- 4.11 Theories of harm will generally fall into the following categories:
- *Unilateral effects*: a worsening of the competitive offers of one or both of the merger firms, and possibly other firms in the market, as a result of the loss of the competitive constraint they would impose on one another without the merger (see paragraphs 4.94 to 4.114).
  - *Coordinated effects*: a worsening of the offer by a number of firms within the market (which could go beyond the merger firms), because the merger creates or strengthens the conditions under which they might collude tacitly (see paragraphs 4.115 to 4.132, which also discuss ‘explicit’ collusion<sup>25</sup>).
  - *Vertical or conglomerate effects*: a lessening of competition that harms consumers, resulting from a merger of producers of products which are not substitutes for one another. These may be inputs to one another (a vertical merger) or complements for, or unrelated to, one another (a conglomerate merger—see paragraphs 4.133 to 4.173).
- 4.12 In some cases, the Authorities may consider several concurrent theories of harm. These may include different effects on the same aspect of competition (for example, unilateral and coordinated effects on price), the same effects on different competitive aspects (for example, unilateral effects on price and on quality), or different effects on different aspects (for example, unilateral effects on price and coordinated effects on capacity). These theories of harm may apply over different time periods—for example, short-run unilateral effects on price and long-run coordinated effects on capacity.
- 4.13 The Authorities thus consider that it is possible for a merger to lead to both unilateral and coordinated effects on the same aspect of competition. In principle, a merger may lead to higher prices in the absence of coordination (unilateral effects) and also

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<sup>25</sup>Both ‘tacit’ and ‘explicit’ collusion may involve actions that are illegal under competition law.

raise the risk of coordination taking place (coordinated effects). The Authorities may not need to form a view on the likelihood of both theories of harm if they expect one of them to be sufficient to meet their respective competition test.

- 4.14 Where several concurrent theories of harm might arise, each of which may not individually constitute an SLC, the Authorities will make an overall assessment of whether or not the relevant SLC threshold is met. Because of the lower threshold of its reference test, the OFT may also consider there to be a realistic prospect of an SLC on the basis of multiple theories of harm that may not be validated according to the CC's 'balance of probabilities' assessment (see paragraph 2.10).
- 4.15 Not all mergers give rise to competition issues. Some will simply not lessen competition substantially, because sufficient post-merger competitive constraints will remain to ensure that competition (or the process of rivalry) continues to discipline the commercial behaviour of the merger firm. Other mergers are either pro-competitive or are competitively benign.

### ***The counterfactual***

- 4.16 The concept of the SLC test involves a comparison of the prospects for competition with the merger against the competitive situation without the merger, ie the counterfactual (see paragraph 4.9). Generally, the Authorities will assess the counterfactual over the foreseeable future, in the same way as the effects of the merger are analysed.<sup>26</sup>
- 4.17 Developments which have arisen or are expected to arise as a result of the merger, while considered as part of the analysis of competitive effects, will not be relevant to the counterfactual.
- 4.18 The impact of the expansion plans of other market participants or the entry plans of one of the merger firms are considered below in the context of the analysis of the merger and potential theories of harm (paragraphs 4.174 to 4.191). But such factors might also be considered in the context of the counterfactual.
- 4.19 In many cases, the appropriate counterfactual will be the pre-merger conditions of competition, and the effect of the merger is judged against a benchmark of all else having been held constant. However, in some circumstances, such as when changes to the structure of the market or to the merger firms are likely in any event, the Authorities may need to take account of other factors so as to reflect the nature of competition in the absence of the merger.
- 4.20 Since the counterfactual may be either more or less competitive than the prevailing conditions of competition (assuming these could be restored following a completed merger), it may increase or reduce the prospects of an SLC finding by the relevant Authority.

### ***The approach to the counterfactual***

- 4.21 In reviewing mergers at Phase 1, the OFT is required to assess whether the merger creates a realistic prospect of an SLC. The 'is or may be the case' standard in the OFT's SLC test also has implications for its approach to the counterfactual (see paragraph 2.4 and its footnote); given a range of plausible counterfactual scenarios,

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<sup>26</sup>The period can sometimes be relatively short, for example in a case where the merged firm was perceived to be failing, eg [British Salt Ltd/New Cheshire Salt Works Ltd](#), CC, November 2005.

the OFT will consider whether the merger creates a realistic prospect of an SLC when compared with the most competitive realistic counterfactual position.

- 4.22 The OFT may therefore conclude that it ‘may be the case’ that the merger may be expected to result in an SLC against a particular counterfactual (ie such that the duty to refer is met), even if there are other realistic counterfactual scenarios under which there would be no SLC.
- 4.23 The OFT’s approach in practice is to presume that the prevailing conditions of competition are the relevant starting point for the counterfactual. For most cases reviewed by the OFT, such a presumption in favour of the status quo, or status quo ante in the case of completed mergers (ie the pre-merger situation), represents a cautious approach to determining the appropriate counterfactual (and therefore whether any prospect of SLC would be caused by the merger under consideration).<sup>27</sup>
- 4.24 However, this presumption may be rebutted—either by evidence about a realistic alternative counterfactual that the OFT considers (given its statutory test) it should take into account in its analysis, or by evidence from the merger parties on the appropriate counterfactual. This means:
- In a situation where the merger firms are both active in a market at the time of the merger, and the counterfactual consideration is whether one of them would have *exited* from the market had the merger not gone ahead, the OFT would require compelling evidence that such exit was ‘likely and imminent’, so as to rebut the presumption that the party in question would have remained to compete in the market<sup>28</sup> (see paragraphs 4.27 to 4.33).
  - Alternatively, the counterfactual question under consideration may be whether one of the merger firms would have *entered* the market, thereby increasing competition, without the merger. In such a situation, the asymmetry of the reference test requires the OFT to move beyond its initial presumption to consider carefully whether it is realistic that such entry would have occurred; such considerations could in some sense be considered as part of the counterfactual, but are more normally treated as theories of harm relating to potential competition.<sup>29</sup>
- 4.25 As a Phase 2 body, the CC, on the other hand, will consider the most likely outcome in the market under investigation and define the counterfactual based upon its expectation. This may often, but not always, be the prevailing conditions of competition. At both Phase 1 and Phase 2, known third party events in the near future (including competitors’ expansion plans and planned regulatory and legislative changes affecting the industry) will be included in the consideration of the counterfactual. No counterfactual can be constructed that involves existing agreements in violation of competition law, eg on cartels.
- 4.26 The following paragraphs set out examples of situations where a counterfactual different from the prevailing conditions of competition may be appropriate.

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<sup>27</sup>See *Anticipated acquisition by Tesco Stores Limited of five former Kwik Save stores (Handforth, Coventry, Liverpool, Barrow-in-Furness and Nelson)*, OFT, 11 December 2007.

<sup>28</sup>For an example of the OFT using a counterfactual other than prevailing conditions, see *First West Yorkshire/Black Prince*, OFT, 27 May 2005.

<sup>29</sup>For an example of the OFT considering potential entry into the market by one of the merger firms, see *Air France-KLM/VLM*, OFT, 9 May 2008.

## *The 'failing firm' defence*

- 4.27 One example of a likely and imminent change in the structure of competition arises where one of the merger parties is about to exit from the market on the basis that it is thought to be failing. The Authorities will consider the implications of the inevitable exit of one of the merger firms or of its assets in the context of the counterfactual. Where parties argue that prevailing, pre-merger conditions of competition are not the appropriate counterfactual because one of the merger firms would have exited from the market (because it had 'failed') without the merger, the Authorities will consider: (a) the inevitability of exit of the firm in question; (b) whether there would be a substantially less anti-competitive alternative buyer for the firm; and (c) whether failure of the firm would be a substantially less anti-competitive outcome than the merger. These considerations are discussed below.

### *Inevitability of exit*

- 4.28 The pre-merger competition conditions may not prevail even if the merger is prohibited if one of the merger firms would have exited from the market in the near future. Typically this issue arises when the firm in question is failing, but it may on rare occasions be for another reason, such as a change in the seller's corporate strategy. In these circumstances, the counterfactual might need to be adjusted to reflect the likely failure or exit and any resulting loss of rivalry.<sup>30</sup>
- 4.29 The Authorities will look at the facts of the case to assess whether one of the firms would inevitably exit from the market. For instance, it may in some circumstances be inevitable that a firm in a perilous situation or in liquidation would exit, but the Authorities will not always accept that a firm on the verge of administration will inevitably exit from the market. (Given the OFT's 'is or may be the case' standard—see paragraph 2.4 and its footnote—it will require compelling evidence.) Decisions by profitable parent companies to close down loss-making subsidiaries or divisions are unlikely to satisfy the criteria that exit was inevitable, though they may do so in exceptional instances.<sup>31</sup> There must also be no serious prospect of reorganizing the business.

### *No substantially less anti-competitive alternative buyer*

- 4.30 Even if exit is inevitable, the Authorities will also consider what could realistically have happened (for the OFT) or would have happened (for the CC) to the assets of the firm that would have inevitably exited. The counterfactual will be based on the Authorities' findings. There may, realistically, be other buyers, whose acquisition of the firm or assets would produce a substantially better outcome for competition than the merger under consideration. These buyers may be interested in obtaining the assets as a means of entering the market. Alternatively, there could be one or more firms already in the market interested in buying the assets.
- 4.31 The OFT, as a Phase 1 body, will not adopt a counterfactual based on an alternative buyer. Instead, if it cannot dismiss as unrealistic the prospect of a substantially more competitive alternative buyer, it will assess the merger against prevailing or pre-merger conditions.<sup>32</sup> For the CC, at Phase 2, if the counterfactual is treated as being

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<sup>30</sup>See, for example, *Thermo Electron Manufacturing Limited/GV Instruments Limited*, CC, May 2007.

<sup>31</sup>See, for example, *Completed acquisition by Home Retail Group plc of 27 leasehold properties from Focus (DIY) Ltd*, OFT, 15 April 2008, and *Long Clawson Dairy Limited/The Millway business of Dairy Crest Group plc*, CC, January 2009.

<sup>32</sup>It would tend to create an unworkable regime of Phase 1 merger control if the OFT were obliged to conduct a competitive assessment of the outcome with the preferred bidder against, for example, the seller's second choice.

one in which the assets would have been sold to an alternative buyer, it will then compare the competition effects of the merger under consideration against the merger contemplated in the counterfactual.

- 4.32 When considering the prospects for an alternative buyer, the Authorities will look at available evidence supporting any claims that the merger under consideration was the only possible merger (ie that there was genuinely only one purchaser for the firm or assets). The Authorities will take into account the prospects of alternative offers above liquidation value. The possible unwillingness of alternative purchasers to pay the seller as high a purchase price or otherwise benefit the target business would not rule out a counterfactual in which there is a merger with an alternative purchaser.

*Failure of the firm is not substantially less anti-competitive*

- 4.33 Even where the Authorities are satisfied that there is no suitable alternative buyer, they will consider whether exit of one of the merger firms (or its assets) and the competition for that firm's market share by the remaining players in the market would be a substantially less anti-competitive outcome than the merger.

*Competing bids and parallel transactions*

- 4.34 The counterfactual may not be the pre-merger prevailing conditions of competition where there is more than one bidder for a target business (but where that target business is not claimed to be inevitably exiting the market).
- 4.35 The OFT will examine each competing bid separately and will consider whether that particular merger creates a realistic prospect of an SLC as against prevailing conditions of competition. It will not engage in a comparative analysis of multiple competing bids. For the CC, however, the appropriate counterfactual will depend on the circumstances of the case, as discussed below.

*One proposed transaction is referred*

- 4.36 If the OFT considers that only one of the contemplated mergers creates a realistic prospect of an SLC, and therefore refers only that merger, the counterfactual against which the CC makes its assessment is likely to be the pre-merger competitive conditions. The CC will define the counterfactual according to its expectations (see paragraph 4.25). In practice, even if the CC forms an expectation that the counterfactual is sale to one of the other bidders, the outcome of the competitive assessment of the merger that is referred will not typically be affected where sale to the alternative bidder does not raise competition issues.

*Two or more bids are referred*

- 4.37 If two or more bids are referred, the counterfactual is unlikely to involve any of the referred mergers because they all raise prima facie competition concerns. Comparison of two or more problematic mergers against each other would permit all such anti-competitive mergers. Except in rail franchise awards (see paragraphs 4.43 and 4.44), the CC will not allow any consideration of possible remedies to dictate its counterfactual analysis and will not consider a 'remedied bidder' as a suitable counterfactual.

- 4.38 Where more than one bid is referred, but there are also bids that are not referred, the former are less likely to form the counterfactual than either the prevailing conditions of competition or one of the alternative mergers that is not referred.
- 4.39 Where all the bids are referred, the counterfactual will generally be the pre-merger situation, although the authorities will consider the appropriateness of the counterfactual being another bid that does not raise prima facie competition concerns.

#### *Parallel transactions*<sup>33</sup>

- 4.40 The Authorities may be required to consider a merger at a time when there is the prospect of another merger in the same market (a parallel transaction<sup>34</sup>).
- 4.41 For the OFT, the question is, as always, whether the transaction under review creates the realistic prospect of an SLC, and it is likely to consider whether the statutory test would be met whether or not the parallel transaction proceeds<sup>35</sup> (unless one of the transactions can clearly be ruled out as too speculative<sup>36</sup>).
- 4.42 For the CC, the relevant counterfactual will depend on whether it expects that parallel transaction to proceed.

#### *Rail franchise awards*

- 4.43 In rail franchise cases, the pre-merger situation cannot be the appropriate counterfactual, as the existing rail franchise is coming to an end and must be re-awarded to one of the short-listed bidders.<sup>37</sup>
- 4.44 The Authorities will therefore treat the appropriate counterfactual to the merger as the award of the franchise either to a firm that raises no competition concerns (in the CC's case, a merger with, or an award to, a bidder that is not referred to it) or, if there is no alternative bidder that does not raise competition concerns, to a hypothetical bidder, with any competition concerns being remedied through behavioural remedies.<sup>38</sup>

### Section C: The SLC test: criteria and methodologies

- 4.45 In considering the SLC test, the Authorities apply analytical criteria and methodologies under the following headings (although the headings are not necessarily systematically followed in their reports):

- (a) market definition;
- (b) measures of concentration;

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<sup>33</sup>Strictly speaking, a parallel transaction does not form part of the counterfactual given that it will occur whether or not the merger proceeds. However, for convenience the issue is addressed in this section.

<sup>34</sup>In this context, a parallel transaction is one which is either anticipated or which has been completed but remains subject to the possibility of being unwound as a result of intervention by the Authorities under the Act.

<sup>35</sup>See *Anticipated acquisition by Nasdaq Stock Market, Inc of the London Stock Exchange plc*, OFT, 18 January 2007, in which the OFT included the merger between NYSE and Euronext as part of its counterfactual notwithstanding that that merger had not yet completed.

<sup>36</sup>The OFT considered that a successful completed bid by Nasdaq for LSE was too speculative to be taken into account as part of the counterfactual in *Anticipated merger between NYSE Group, Inc. and Euronext N.V.*, OFT, 9 October 2006.

<sup>37</sup>See, for example, *Stagecoach/East Midlands passenger rail franchise*, OFT, 4 February 2008.

<sup>38</sup>See *Greater Western Passenger Rail Franchise*, CC, March 2006.

- (c) horizontal mergers—unilateral effects (including any vertical effects of horizontal mergers);
- (d) horizontal mergers—coordinated effects;
- (e) non-horizontal mergers;
- (f) barriers to entry and expansion;
- (g) countervailing buyer power; and
- (h) efficiencies.

**(a) Market definition**

- 4.46 In assessing the effects of a merger, it is important to identify the competitive constraints faced by the merger firms. The process of defining the relevant market is intended to provide a helpful framework for assessing the relevance of different constraints and distinguishing clearly between them. (Paragraphs 4.49 and 4.50 describe the nature of these constraints.) Market definition may therefore be considered concurrently with the assessment of competitive effects of the merger.
- 4.47 Market definition is a useful tool but is not an end in itself. In particular, unilateral effects (see paragraphs 4.94 to 4.114) do not necessarily turn on market definition: ie the unilateral effects arising from a horizontal merger will typically be the same regardless of whether the merger is framed as one generating high concentration within a narrow market, or as one involving the loss of close, direct competition within a broader market. Failing to recognize this has been termed the ‘binary fallacy’.<sup>39</sup>
- 4.48 Since the process of market definition can be time consuming and resource intensive, the Authorities may not conclude on a market definition and may instead consider several alternative market definitions as part of the investigation. For example, it may not be necessary to decide on the boundaries of the relevant market, when the Authorities would reach the same conclusions as to the effects of the merger under different market definitions. This is, however, less likely to be the case when the CC concludes that a merger has resulted or may be expected to result in an SLC.
- 4.49 Consideration of the likely relevant market(s) can be helpful to formulate or discount theories of harm against which to analyse the market. In addition, market definition is needed to calculate market share and concentration measures which can be used as part of the competitive assessment of the merger.
- 4.50 There are normally two dimensions to the definition of the relevant market: a product dimension and a geographic dimension. The products that should be included in the relevant market, and the geographic boundaries of that market, are generally determined by reference to demand-side substitution alone—ie the extent which customers can readily switch to substitute products and geographic areas, depending on the alternative sources of supply currently available in the market. However, the likely reactions of firms not currently supplying goods in the relevant market to a change in competitive conditions (ie a supply-side reaction) also has to be assessed. This will lead to the identification of those firms which may be considered to impose a

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<sup>39</sup>The ‘binary fallacy’ is the assumption that all firms ‘in’ the market exercise competitive constraints upon one another in proportion to their market shares but that firms ‘outside’ the market exercise no competitive constraint at all on firms ‘in’ the market.

competitive constraint—and therefore may be considered to be competitors—in the relevant market<sup>40</sup> (see paragraphs 4.68 to 4.71).

- 4.51 This approach may, in some specific cases, lead to defining markets that are not the most practical for conducting the competitive assessment. This occurs where firms supply multiple products that are not demand-side substitutes and can immediately switch the proportion they supply of each of these non-substitutes. If virtually all the firms in the relevant market are in that position, the Authorities may aggregate for convenience the various individual markets that would be identified through demand-side substitution alone and analyse competitive constraints by reference to one relevant market.<sup>41</sup>

### *Hypothetical monopolist test*

- 4.52 There is inevitably an element of judgement involved in defining the market and the Authorities will adopt the most appropriate methodology in the context of the merger. The generally accepted conceptual approach to market definition is the hypothetical monopolist test.<sup>42</sup> The Authorities will adopt this concept wherever it is useful and practicable to do so. In practice, the hypothetical monopolist test will often be applied only at the conceptual level and will not in all cases be formally applied.
- 4.53 The hypothetical monopolist test is iterative. It begins by considering each product (narrowly defined) supplied by each of the merger firms. The following question is then asked: if there were only one supplier (a hypothetical monopolist) of a certain product or set of products (the candidate market), would it be able profitably to raise prices, or otherwise worsen its offer, by a small but significant and non-transitory amount? (When the hypothetical monopolist test is implemented in respect of price, it is commonly known as the ‘small but significant and non-transitory increase in price’—or SSNIP—test.) If this is unprofitable, because customers would switch consumption to other products, then the closest substitutes are added to the product group and the procedure is repeated. In this way, the Authorities seek to establish the narrowest set of products that can be monopolized profitably. This is the ‘relevant market’.
- 4.54 In applying the SSNIP test, some analysis of the characteristics of the product, including its intended use, may be necessary so as to establish which possible substitutes might be next included in the product group.

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<sup>40</sup>Take as an illustrative example the liquid egg market (which the CC considered in [Stonegate Farmers Ltd/Deans Food Group Ltd](#), CC, August 2007). Many liquid egg producers use the same production technology but suppose producers of fruit ‘smoothies’ could also, with slight adaptations to their production process, manufacture liquid egg. As ‘smoothies’ and liquid egg are not demand-side substitutes, they would not form part of the same relevant market, according to the Authorities’ market definition approach. Nonetheless some or all suppliers of fruit smoothies—depending on their incentives and ability to react in a competitive way to changes in the liquid egg market—might be judged to compete in this market and competitors’ shares of capacity might be calculated on that basis. While participants in the liquid egg market might therefore include not only liquid egg suppliers but also some suppliers of fruit smoothies, the supply-side reactions of the latter would not mean that the market would be defined as ‘liquid egg plus fruit smoothies’.

<sup>41</sup>An example of this type of analysis is the supply of clothes. Clothes of different sizes are clearly not demand-side substitutes for a customer of a given size. However, almost all clothes manufacturers supply a similarly broad range of sizes for each garment. In this case, it might be more helpful for the Authorities to define a product market for clothes of the appropriate type but encompassing all different sizes, rather than conducting separate analyses for product markets corresponding to each size.

<sup>42</sup>The hypothetical monopolist test is used to identify constraints on the ability of the hypothetical monopolist that arise because of demand-side substitution. As a result, when applying the test, it will generally be assumed that prices of products outside the candidate market and the supply decisions of those firms outside the candidate market are held constant.

## *Product market*

- 4.55 For the SSNIP test, the Authorities will normally apply a price increase of 5 per cent whilst assuming that all other prices remain unchanged. However, in some markets a different price increase may be postulated. This could be above or below 5 per cent. The guiding principle in this regard is that the price increase applied should be one that is judged small but significant in the particular market under consideration and is assumed to last for a non-transitory period.
- 4.56 When the candidate market comprises several different products<sup>43</sup> and price discrimination is possible, a hypothetical monopolist might choose not to increase its prices uniformly across the products it sells, but to do so variably depending on the degree of market power it enjoys for each product. This will be reflected in the application of the hypothetical monopolist test: in particular, the Authorities will generally assume that the hypothetical monopolist will increase its prices by 5 per cent on average but not necessarily uniformly, and will instead implement different price increases to its customers in a way that would lead to the highest profit.
- 4.57 Customers in the candidate market may differ in their ability and willingness to switch to other suppliers. If this is the case and if it is possible for firms in the candidate market to identify these different groups of customers and price differently to them, consideration will be given to specific markets that coincide with subsets of customers within the candidate market.
- 4.58 In most cases, a hypothetical monopolist test would be conducted relative to prevailing prices. Where significant market power is already being exercised in the candidate market, the prevailing price may be substantially higher than the competitive price. If this is the case, a hypothetical monopolist test conducted at prevailing prices may lead to defining a broader market than if the test were conducted at competitive price levels. This problem is known as the ‘cellophane fallacy’.<sup>44</sup> In cases where it is thought that prevailing prices might be the outcome of coordinated behaviour (see paragraphs 4.115 to 4.132), the Authorities may consider conducting the test using prices lower than prevailing prices as a starting point. This helps to ensure that the relevant market includes only those products which place the closest constraint on each other and over which coordination might be taking place. It should also exclude products which are not relevant. (On rare occasions, prices could be ‘too low’ relative to their competitive level; if so, the ‘reverse cellophane fallacy’ may make markets appear narrower than they are.)<sup>45</sup>
- 4.59 Following a SSNIP, there will be a decline in the quantity sold, as customers buy less of the product because of demand-side substitution. The overall effect of a SSNIP on the hypothetical monopolist’s profits will therefore depend on the net effect of two factors:
- the increase in revenue on the quantity sold that is retained, as the price at which that quantity is sold increases; and
  - the profit forgone on the quantity sold that is lost.
- 4.60 Measurement of both factors requires information on actual costs and profit margins and how these change with the amount produced.

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<sup>43</sup>This applies also to the same product sold in different geographical locations.

<sup>44</sup>See *US v El Du Pont de Nemours & Co* [1956] 351 US 377 (see <http://supreme.justia.com/us/351/377/>).

<sup>45</sup>See *Sportech plc/Vernons*, CC, October 2007.

- 4.61 Demand-side substitution occurs because an increase in price makes a product less attractive to customers. A measure of demand-side substitutability, known as the elasticity of demand, looks at the responsiveness of demand to changes in price, with all other prices remaining unchanged. In implementing the hypothetical monopolist test, two elasticities of demand are commonly taken into account: the own-price elasticity of demand and the cross-price elasticity of demand. The own-price elasticity of demand measures the responsiveness of the demand for a product to a change in its own price; the cross-price elasticity of demand measures the responsiveness of demand for a product to a change in the price of a different product.<sup>46</sup>
- 4.62 The types of information set out below can, when available, be useful in the analysis of demand-side substitution:
- product characteristics such as physical properties and intended use;
  - responses from customers, competitors and interested and informed third parties to questions—sometimes posed in surveys—about customer behaviour and the hypothetical monopolist test;
  - documents such as marketing studies, consumer surveys, market analyses prepared for investors, and internal business analyses (eg board papers, business plans and strategy documents)—the Authorities will also consider any similar types of studies, such as surveys, that have been prepared specifically for the inquiry;
  - information about relative price levels and the extent to which they move together over time;
  - information enabling the estimation of ‘switching costs’ that customers might incur in changing from the product of one supplier to that of another—these may be monetary or non-monetary, eg the time, effort and uncertainty involved in switching suppliers;
  - information about switching behaviour, or shifts in sales patterns, and the extent to which these relate to changes in price differentials, over time or across different areas;
  - estimates of own-price, and cross-price, elasticities of demand, for example from econometric studies or previous pricing experiments; the value of econometric estimates as evidence depends mainly on the appropriateness of the statistical models used and on the quality of the underlying data—consequently, when submitting such evidence to the Authorities, parties should include any necessary data and algorithms to enable the Authorities to reproduce and assess the appropriateness of their econometric analysis;<sup>47</sup> and

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<sup>46</sup>An own-price elasticity of  $-1$  means that a 5 per cent increase in the price of the product results in a 5 per cent decrease in the quantity sold of that product. Demand is said to be elastic when the own-price elasticity is more negative than  $-1$ —that is, when a 5 per cent increase in price leads to a greater than 5 per cent fall in the quantity sold. Demand is inelastic when the elasticity is less negative than  $-1$  (ie is closer to zero). Similarly a cross-price elasticity of  $+1$  means that a 5 per cent increase in the price of product A results in a 5 per cent increase in the quantity sold of product B. For products A and B to be substitutes, the cross-price elasticity between them must be positive (as an increase in the price of one product leads consumers to substitute to the alternative product). For products A and B to be complements, cross-price elasticity between them must be negative (as an increase in the price of one product leads consumers to buy less also of the alternative product because they are complementary, ie are consumed together).

<sup>47</sup>The OFT is less likely than the CC to undertake its own alternative econometric analysis in the light of any analysis produced by the merger parties. Suggested best practice for submission of technical economic analysis from parties to the Authorities is at: [www.competition-commission.org.uk/rep\\_pub/corporate\\_documents/corporate\\_policies/best\\_practice.pdf](http://www.competition-commission.org.uk/rep_pub/corporate_documents/corporate_policies/best_practice.pdf); and [www.competition-commission.org.uk/press\\_rel/2009/feb/pdf/07-09.pdf](http://www.competition-commission.org.uk/press_rel/2009/feb/pdf/07-09.pdf).

- information from the merger firms on their actual costs and profit margins, and how these change with production volumes.<sup>48</sup>

4.63 This information may be supplemented by other calculations, eg:

- estimates of the sales that must be lost before a given price increase would be unprofitable (sometimes referred to as ‘critical loss’): this would then be judged against the actual loss that is likely to result from the hypothetical monopolist imposing a SSNIP on the candidate market; and
- estimates of the maximum own-price elasticity of demand that would still make an increase in price profitable (sometimes referred to as ‘critical elasticity’).

Such calculations may help the Authorities to judge how likely it is that a SSNIP would be profitable.

### *Geographic market*

4.64 The relevant geographic market is the smallest area in which a hypothetical monopolist could profitably sustain a SSNIP. The relevant geographic market may be local, regional, national or wider. Imports may be taken into account as well as UK products.

4.65 Where available, similar information to that used to identify substitution in the product market can be used to assess the geographic boundaries of the market. In particular, the Authorities might consider the following:

- responses from customers, competitors and interested and informed third parties to questions on consumer preferences by geographic area;
- information enabling the estimation of ‘switching costs’ that customers might incur in changing to products supplied in other geographic areas (which can include additional delivery costs) relative to the value of the products and the length of time taken to make the switch;
- product characteristics such as perishability;
- information on differences in pricing, sales, advertising and marketing strategies by area; and
- information on flows of goods between regions or into the UK and any barriers to entry, whether legislative, natural or strategically created.

4.66 The Authorities will also consider whether customers would increase their purchases from overseas suppliers if domestic producers’ prices were increased (perhaps suggesting that the market is wider than the UK). Even when imports account for a small proportion of UK consumption, it might be relatively easy for customers to switch. However, there can be obstacles to customers purchasing more from overseas, or to overseas producers increasing their UK supply, for example transport costs, capacity constraints, trade barriers, national standards or regulations.

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<sup>48</sup>There is an inverse relationship between the price-cost margin earned by a firm and the elasticity of demand (mentioned in the preceding bullet point) that it faces. This inverse relationship means that a firm's price-cost margin and the elasticity of demand that it faces are not independent of one another and the Authorities will expect estimates of both to be consistent with each other.

4.67 For certain mergers—in particular, those involving chains of retailers operating over multiple local geographic markets (such as supermarkets)—it may not be feasible for the Authorities to define precisely the boundaries of each of the numerous relevant local geographic markets. In such situations, the Authorities may adopt a candidate geographic market definition that provides a practical solution to market definition over multiple local markets. In particular, the Authorities may examine the geographic catchment area within which the great majority (usually 80 per cent or more) of the retailers’ custom is located.<sup>49</sup> The boundaries of that catchment area will depend on how far the great majority of customers travel and what mode of transport they use. In general, the Authorities are likely to consider that such catchment areas are best defined on the basis of time travelled,<sup>50</sup> although they may occasionally consider catchment areas based on distance.<sup>51</sup>

### *Constraints from firms’ reactions*

4.68 As set out above (paragraph 4.51), the Authorities will consider the likely reaction to a change in competitive conditions of firms not currently supplying products in the relevant market. This leads to the identification of those firms that, while not currently supplying products in the relevant market, represent a competitive constraint for those firms that do, and can therefore be considered to be competitors in the relevant market. Firms’ reactions to, say, a price increase will be considered likely to result in a competitive constraint on a hypothetical monopolist if:

- firms’ reactions are such as to reduce the profitability for the hypothetical monopolist of such price increase; and
- such firms can be seen to have both the ability and the incentives to react in this way.

4.69 The Authorities recognize that the ability of firms to react to changes in market conditions, and the extent to which this might translate into a competitive constraint, may vary significantly between firms or geographic areas. This will be likely to depend on a broad set of factors, not all of which are necessarily related to competitive conditions in the market where the merger firms operate.<sup>52</sup> In identifying competitive constraints in the market, the Authorities will consider the likelihood and extent of each firm (or group of firms)<sup>53</sup> reacting in such a way and therefore being considered to compete in the relevant market.

4.70 It is not always simple to distinguish a firm (or group of firms) that could become a competitor in the market because of its likely supply reaction from one that could be

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<sup>49</sup>Typically, the Authorities do not derive a retail outlet’s catchment area based on the location of 100 per cent of its custom. This is because consumers shop at retail outlets when they are on holiday, for instance, and a catchment area that did not recognize this would give a distorted picture of local competition.

<sup>50</sup>That is, if the great majority of a retailer’s custom is located within 10 minutes’ travel time, then the Authorities may consider a catchment area based on all points 10 minutes’ travel time from each retail outlet. Such a locus of points is known as an isochrone.

<sup>51</sup>The Authorities recognize that some retail outlets (eg bookshops) may not attract dedicated customers as a shopping destination in the way that others do (eg supermarkets, cinemas or DIY stores), and may instead rely more on passing trade. Retail outlets relying on passing trade may be best thought of as competing locally with other outlets within a specified distance, rather than within an isochrone (bookshops on the same ‘high street’, for example).

<sup>52</sup>For example, the likelihood of a given firm switching some capacity to the market where the merger firms are active in response to a worsening of the merged firm’s offer might depend not only on the margins that the firm is likely to earn in that market but also on its forecast of future margins in its current market as well as broader strategic considerations that might not be captured by an assessment only of the time and costs involved in switching.

<sup>53</sup>For example, a group of firms currently supplying a product which is not a demand substitute may, for various reasons, have different incentives to switch their capacity to supplying products in the relevant market. If some, but not all, producers would switch capacity, considering all producers as competitors in the relevant market would overstate their overall competitive constraint.

seen as a potential new entrant. The difference is typically one of timing and/or investment. Supply-side reactions from competitors usually occur in the short run with little or no investment required, whereas new entry might occur over a longer period and require significant investment. A competitor's supply-side reaction would normally occur within a year of a price rise (although the Authorities recognize that the exact time period may depend on the nature of the market considered) and would not involve significant investment (including in plant, equipment, skills or marketing). Significant investment or set-up costs, especially those that firms consider unlikely to be recoverable, will typically lead to the associated supply reaction being considered under 'entry'.

4.71 The following are examples of the types of information that can be useful, when available, in distinguishing between the supply reactions of competitors and possible entrants:

- information on past supply-side reactions satisfying conditions set out in paragraph 4.68 (for example, information on the extent to which supply-side reaction has resulted from variations in price differentials over time);
- information on adjustment costs and profit margins for those suppliers that are being considered;
- information on the production processes involved;
- the extent of spare capacity within the industry; and
- the business plans of potential suppliers and the assessment of their competitive threat by firms in the market.

#### *Other aspects relevant to market definition*

4.72 When defining the market, there may be other issues that need to be taken into account because of the characteristics of the market. The following paragraphs describe some of these issues.

#### *Asymmetric constraints*

4.73 The result of the hypothetical monopolist test may depend on the starting point chosen. In particular, as firms often differ from one another in several important ways, the competitive constraints they impose on each other may not be symmetric. In other words, a hypothetical Firm A may constrain Firm B's pricing behaviour while Firm B's prices have no effect on A's pricing strategy. An example of this might be grocery retailing, where large stores might constrain the prices of smaller stores while the reverse may not be true.<sup>54</sup> One consequence of this is that market definition in different merger cases in the same sector may not coincide: in grocery retailing, a merger of small grocery stores may take place in a relevant market that includes large grocery stores but a merger of large grocery stores may take place in a relevant market that does not include small grocery stores.

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<sup>54</sup>See, for example, *Somerfield plc/Wm Morrison Supermarkets plc*, CC, September 2005, and *Anticipated acquisition by Co-operative Group Limited of Somerfield Limited*, OFT, 20 October 2008.

### *Intermediate markets and indirect constraints*

- 4.74 Some products are not sold directly to the final consumer. They are first sold to an intermediary, who then either sells on directly to another customer (a wholesaler) or reprocesses the products before resale (a reprocessor). Markets for products at an earlier stage of production are generally designated as upstream markets; and those at a later stage, typically the retail stage, downstream markets.<sup>55</sup> In general, when goods are not sold directly to final consumers they are said to be sold in an 'intermediate market'. Such markets may raise particular issues for market definition.
- 4.75 First, in many intermediate markets, prices are negotiated bilaterally between suppliers and sellers rather than unilaterally set by a supplier. In these cases it might be more appropriate to assess constraints by directly assessing the determinants of bargaining strength rather than conduct a standard SSNIP test analysis.
- 4.76 Second, where there are upstream and downstream markets, as well as considering which aspect of the supply chain should be included in the definition of the relevant market, the Authorities will need to consider, in their assessment of the competitive effects of the merger, the potential for upstream and downstream markets to influence each other. For instance, in a horizontal merger involving upstream firms supplying an input, the demand faced by the merger firms will depend not only on the direct horizontal constraints they face from other upstream firms supplying the input but also on the indirect vertical constraints imposed by competition between makers of the final products that use the input. Although customer preferences at one level of the supply chain will be determined by customer preferences further down the supply chain, they will not in general necessarily be the same;<sup>56</sup> where price increases are relatively small and indirect vertical constraints relatively weak, for example, intermediaries are sometimes able to pass on all or most of any upstream increases to downstream customers.<sup>57</sup>

### *Chains of substitution*

- 4.77 When products are differentiated, pairs of these products may display different degrees of substitutability. For example, products A and B may be close substitutes and products B and C may also be close substitutes; but the same may not be true for products A and C. Identifying such sequences of pairs of substitutes—or 'chains of substitution'—while it may seem intuitive, does not necessarily provide an indication of the substitutability of products at non-adjacent places in the chain, and the Authorities will not necessarily draw a conclusion from it. They will instead prefer to apply the methodology of the hypothetical monopolist test (paragraphs 4.52 to 4.54) to assess whether different products should be included in the relevant market.

### *Multi-sided markets*

- 4.78 In some markets, firms serve different and unrelated groups of customers. Nonetheless, the number of customers in each group may affect the value of the product or service sold (so-called 'network effects'). One such example is newspapers (and other media markets) where both readers (or viewers, or listeners) and advertisers are served and where the value of the product (eg an advertisement) to one group of customers (advertisers) is affected by the number of customers served in the other

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<sup>55</sup>See footnote to paragraph 4.16.

<sup>56</sup>See, for example, [Heinz/HP Foods Group](#), CC, March 2006, and [Anticipated acquisition by Nike, Inc of Umbro plc](#), OFT, 16 January 2008.

<sup>57</sup>See, for example, [Nufarm/AH Marks](#), CC, February 2009.

group (the number of readers of a newspaper or viewers of a channel). Such 'externalities' across customer groups complicate the process of market definition.

- 4.79 In multi-sided markets, it may be more difficult to conduct an empirical hypothetical monopolist test as calculations of both actual and critical losses (see paragraph 4.63) need to take into account the size of any externality across customer groups, and this will typically increase the uncertainty of a specific empirical measure. Furthermore, firms may adopt radically different business strategies, even implying large price differentials (for example, a free, advertising-funded newspaper versus one that is sold at a positive price to readers) while still competing for the same customers. Understanding the scale of any indirect externalities between groups of customers in such cases provides the Authorities with an indication of how strategies and competitive constraints may evolve in the future and as a result of the merger.<sup>58</sup>

#### *Secondary product markets*

- 4.80 Secondary (or aftermarket) products are those that are purchased only as a result of the customer having purchased a primary product. Examples include spare parts for durable goods such as car parts for cars, razor blades for razors, cartridges for printers or mortgage payment protection insurance for mortgage repayments. It may be necessary to consider whether the primary market (car, razor, printer, mortgage etc) and secondary products (parts, blades, cartridges, insurance etc) are one composite good when defining the relevant market. There are typically three types of secondary product market:

- *a system market*: a unified market for the primary product and the secondary product (eg a market including all razors and all razor blades from different manufacturers);
- *multiple markets*: a market for primary products and separate markets for the secondary product(s) associated with each primary product (eg one market for all razors but individual markets for each razor manufacturer's razor blades); and
- *dual markets*: a market for the primary product and a separate market for the secondary product (eg one market for all razors and a separate market for all razor blades).

- 4.81 In mergers between providers of secondary products, the approaches may differ depending on whether a system market, multiple or dual markets are defined.<sup>59</sup> The appropriate definition depends on the facts of the case. A system market definition may be appropriate either where customers engage in whole-life costing (in the case of a durable good)<sup>60</sup> or more generally where competition in the primary market feeds through into significant competitive constraints in the secondary product markets. Such a situation can arise when consumers choose the primary product on the basis of the characteristics and in particular price of both the primary and secondary products. Alternatively, reputation effects may mean that a significant price increase for the secondary product would harm a supplier's overall profits by reducing future sales of its primary product. In other cases, a multiple market or a

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<sup>58</sup>For further discussion of multi-sided markets and 'network effects', see also paragraphs 4.97, 4.182–4.184, 4.191 and 4.215–4.217.

<sup>59</sup>If, for example, the merger firms provided razor blades for the same type of razor, the merger may raise significantly more concerns under a 'multiple market' definition (where there may be fewer remaining companies providing the same razor blades) than under a 'system market' definition where there may be more options.

<sup>60</sup>Where customers take into account the cost of the service provided for the primary product, including the cost of purchasing the secondary product, when they decide which primary product to purchase.

dual market may be the appropriate definition. The former is likely where, having purchased a primary product, customers are (actually or effectively) locked in to using only a restricted number of secondary products that are compatible with the primary product. The latter definition may be appropriate where secondary products are compatible with all primary products (and perceived to be so by customers).

#### *Captive production*

- 4.82 Transactions involving vertically-integrated firms—which supply the upstream input to themselves and sell the downstream product—raise the issue of whether supply of the input consumed internally ('captive production') should be considered in the product market or whether only supply of the input to third parties (ie the 'merchant market') should be included. The Authorities will generally follow the principle that captive production will be included in the market only if it can be demonstrated that it would be profitable for the supplier to forgo captive use and sell into the merchant market in response to a SSNIP of the product in the merchant market.

#### *Competition through R&D*

- 4.83 In some sectors competition takes place through R&D investment and the resulting innovations. In these cases, the Authorities will seek to define the market by reference to firms' competitive R&D efforts. However, in doing so it may be difficult to distinguish competitive constraints arising through demand-side substitution from those deriving from supply-side reactions. Consequently, it may be difficult to adopt the approach to assessing supply-side reactions described above (paragraph 4.51).<sup>61</sup> In such cases, the Authorities might rely more on direct evidence of which products and competitors exercise the closest constraint on the merged firm.

### **(b) Measures of concentration**

- 4.84 Although the definition of the relevant market is only a starting point for the assessment of a merger, the level of concentration in the relevant market, as defined, can be an indicator of the competitive pressure in that market. The more concentrated a market, the weaker the competitive constraints on the merged firms are generally likely to be.
- 4.85 A straightforward count of the firms in a market is only a basic measure of concentration because it does not convey much information about the structure of the market—it fails to take into account, for example, differences in market shares and the size distribution of firms.<sup>62</sup> Consequently, in assessing market concentration, the Authorities may have regard to three commonly-used measures: market shares, concentration ratios and the Herfindahl-Hirschman Index (HHI).

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<sup>61</sup>In R&D-intensive industries firms may compete to differentiate their products from their competitors' via innovations and win customers as a result. In these markets, at any given time, there may be little demand-side substitution between the various products sold (possibly also as a result of intellectual property rights). However, likely future demand-side substitution determines the type of R&D investment which is more likely to win customers. In these cases, considering demand-side substitution alone might lead to markets that are too narrow and do not provide a helpful framework for the assessment. Conversely, supply-side substitution in isolation might lead to markets that are too broad and include products that are not necessarily demand substitutes.

<sup>62</sup>It may nonetheless be used as a filter in local retail mergers to identify local geographic markets where the merger appears likely to raise concerns. See further paragraphs 4.94–4.101.

- 4.86 The Authorities will attach less weight to these measures of concentration in cases where they cannot be definitive about the boundaries of the relevant market than in cases where they can.<sup>63</sup>
- 4.87 They may also view evidence of turbulence in concentration (eg movements in market shares over time) as indicative of intense dynamic competition, regardless of the static level of concentration in a market.

### *Market shares*

- 4.88 The shares of firms in the market, both in absolute terms and relative to each other, can give an indication of the potential extent of a firm's market power. The combined market shares of the merger firms can provide an indication of the change in market power resulting from a horizontal merger.
- 4.89 Market shares may be measured by sales revenue, production volumes, sales volumes, capacity or reserves. Current market shares may be adjusted to reflect imminent and certain future changes, such as the addition of extra capacity.

### *Concentration ratios*

- 4.90 Concentration ratios measure the aggregate market share of a small number (three or four generally) of the leading firms in a market (eg the three-firm concentration ratio, or C3, shows the proportion of the market supplied by the three leading firms). The ratios are absolute in value and take no account of differences in the relative size of the firms that make up the leading group.

### *Herfindahl-Hirschman Index*

- 4.91 The HHI is a measure of market concentration that takes account of the differences in the sizes of market participants, as well as their number, but in practice the Authorities rely on it only rarely.
- 4.92 The HHI is calculated by adding together the squared values of the percentage market shares of all firms in the relevant market. The change in the HHI (known as the 'delta') can be calculated by subtracting the market's pre-merger HHI from its expected post-merger HHI.<sup>64</sup> Nonetheless, the absolute level of the HHI post-merger and the delta arising from the merger can provide an indication of the change in market structure resulting from the merger.
- 4.93 While the Authorities will not (to the extent that they rely on it) employ a mechanistic approach to the use of HHIs (or any other measure of concentration), they may have regard to the following thresholds:<sup>65</sup> any market with a post-merger HHI exceeding 1,000 may be regarded by the Authorities as concentrated and any market with a post-merger HHI exceeding 2,000 as highly concentrated. In a concentrated market,

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<sup>63</sup>Post-merger market share and concentration calculations assume that the post-merger share of the merged firm is simply the sum of the merger firms' pre-merger shares; such post-merger calculations are therefore not definitive partly because the sum of the pre-merger shares is not necessarily the same as the share of the market the merged firm can be expected to capture.

<sup>64</sup>Hence, a market of four firms with market shares  $a$ ,  $b$ ,  $c$  and  $d$  will have an HHI of  $a^2 + b^2 + c^2 + d^2$ . The delta ( $\Delta$ ) in the HHI in this market arising from a merger between the two firms with market shares  $a$  and  $b$  is therefore  $((a+b)^2 + c^2 + d^2) - (a^2 + b^2 + c^2 + d^2) = \Delta$ . Consequently, the delta can also be calculated as  $2ab$  (given  $(a+b)^2 = a^2 + b^2 + 2ab$ ). Given that the shares of all market participants may not be known, it may not be possible to calculate the HHI, in which case the Authorities may, where appropriate, calculate only the delta from the market shares of the merger firms.

<sup>65</sup>These thresholds are in line with European Commission guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings—Commission notice (2004/C31/03).

a horizontal merger generating a delta exceeding 250 may give cause for concern over anti-competitive effects, as may a horizontal merger in a highly concentrated market generating a delta exceeding 150 (non-horizontal mergers do not generate an increase in market share or a delta).<sup>66</sup>

### ***(c) Horizontal mergers—unilateral effects***

#### *Horizontal effects*

- 4.94 Unilateral effects occur when a horizontal merger makes it easier for the merged firm to exercise market power independently, without the need for coordinated action with other firms in the relevant market. An example would be where a worsening of either of the merger firm's competitive offer would, without the merger, have been unprofitable, since it would have had lower sales, but where, post-merger, those sales that would have been lost to the other merger firm are recaptured and its offer becomes profitable.
- 4.95 Other firms in the market may also benefit from the poorer offer of the merged firm. Some may find it profitable to worsen their competitive offers to customers in response, providing another instance of firms pursuing their individual interests without there being a need for any coordination. The worsened competitive offer of the merged firm will cause some customers to switch to rival firms, thereby increasing demand for the rivals' products and allowing the rivals to worsen their offers without losing customers. If this is the case, any harm caused by the merger would not be limited to those customers who are served by the merged firm but would extend to other (and possibly all) customers in the relevant market. The Authorities will usually be concerned primarily with unilateral effects on the customers of one or both of the merger firms, but may also take account of effects on the customers of other firms in the market.
- 4.96 The extent to which unilateral effects will occur depends on how individual competitors will actually respond to an attempted worsening of its offer by a merged firm.

#### *The effect of the merger on competition*

- 4.97 The Authorities will use theories of harm to frame their analysis of possible unilateral effects on the relevant aspects of competition (see paragraphs 4.10 to 4.15). These theories of harm will depend on the nature of intra-market competition. Some commonly considered forms of such competition include:
- markets where competition involves the setting of a market price and where products are undifferentiated but where firms may differ in their production capacity;
  - markets where competition involves the setting of a market price and where products are differentiated in terms of branding and/or quality;
  - markets where competition involves a price-formation mechanism that does not generate a market price, eg in intermediate product markets characterized by

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<sup>66</sup>These thresholds may be most informative for mergers in a market where the product is undifferentiated and where competition between firms involves the setting of a market price for this undifferentiated product when firms face constraints on their capacity to supply it.

bilateral negotiation, in markets characterized by bidding processes<sup>67</sup> or in multi-sided markets with externalities such as direct or indirect network effects (see paragraphs 4.78 and 4.79); and

- markets where firms compete on longer-term non-price factors, such as variety, quality, production capacity or innovation.

4.98 The Authorities may also consider unilateral effects arising from the elimination of potential competition as opposed to actual competition and unilateral effects arising from increased buyer power (see paragraphs 4.110 to 4.112).

### *Assessing horizontal unilateral effects*

4.99 Set out below are the factors most commonly considered when assessing horizontal unilateral effects. Not all need to be present for unilateral effects to arise.

#### *Firm numbers and market share*

4.100 Unilateral effects are generally more likely, particularly in undifferentiated product markets, where:

- there are few firms in the affected market(s);
- the merger results in a firm with a large market share<sup>68</sup>—in general, the larger the market share of the merged firm, the greater is the potential for market power;<sup>69</sup> and
- there is no strong competitive fringe, ie there is no firm or group of firms that would be likely to apply sufficient competitive pressure on the merged firm to prevent it exercising market power.

4.101 In considering retail chain mergers (ie mergers of retail outlets in multiple local geographic areas, such as in the case of supermarkets), the OFT (and to a lesser extent the CC) may use 'fascia counts' (a simple count of the number of retail chains in the local geographic market) as a 'filter', particularly when the merger involves a large number of local geographic markets. In such circumstances, the fascia count filter is used as a starting point to identify possibly problematic local geographical markets warranting further analysis.<sup>70</sup>

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<sup>67</sup>For a discussion, see Paul Klemperer, *Bidding Markets*, CC working paper, June 2005, and OFT economics discussion paper OFT923, *Markets with bidding processes*.

<sup>68</sup>The Authorities do not consider there to be any specific 'safe harbour' level of the combined market shares of the merger firms below which concerns over unilateral effects may be ruled out. However, previous OFT decisions suggest that combined market shares of less than 40 per cent will not often give the OFT cause for concern over market power leading to unilateral effects.

<sup>69</sup>When assessing the potential for adverse effects on customers of firms in the market other than the merger firms, the Authorities may consider market concentration and the market shares of other firms.

<sup>70</sup>Previous OFT decisions in local retail mergers suggest that OFT concern at 5-to-4 and above has been unusual, at 4-to-3 has been occasional, at 3-to-2 has been common and at 2-to-1 has been very likely. Frequently in such mergers, the OFT has found there to be national and local aspects to competition. In selecting its 'intervention threshold' at the local level, the OFT has therefore sometimes had regard to the number of competitors needed to ensure effective competition at the national level. For example, in cases where the OFT has found that four retail chains have been sufficient to ensure competition at the national level, it has on occasion used a 5-to-4 fascia count as a 'filter' at the local level.

### *Closeness of competition*

- 4.102 The merger firms may supply differentiated products—ie products that are sufficiently similar to lie within the relevant market but are not perfect substitutes for each other. In such mergers, unilateral effects are more likely where these differentiated products compete closely, each representing the best alternative to the other for at least a substantial volume of their customers' business. This might be because the merger firms' products are close substitutes in terms of branding or quality. Alternatively, the merger firms could be situated close to each other: where competitors are located within close proximity, even if within a large relevant geographic market, competition can be localized and the geographic location of suppliers will play a significant competitive role. If firms producing close substitutes (in the product and/or geographic sense) merge, the merged firm is more likely to increase price than if competitors not producing close substitutes merge. However, if other firms can alter their products to become close substitutes for those of the merged firm, unilateral effects may be mitigated.
- 4.103 A good measure of the closeness of competition between firms supplying differentiated products is the diversion ratio between them. In a situation where Firm A worsens its competitive offer and this leads to a loss of custom, the diversion ratio between Firm A and Firm B is the proportion of this lost custom that diverts to Firm B. The ratio can be established by estimates of elasticities<sup>71</sup> and from data collected, for example, from consumer surveys,<sup>72</sup> or from 'event' analysis of firms entering and leaving the market.<sup>73</sup> A significant diversion ratio suggests relatively close competition between the merger firms, which the merger would remove.
- 4.104 The combination of diversion ratios and gross profit margins (ie sales minus direct costs of sales) can give a strong indication of unilateral effects.<sup>74</sup> These two factors together help quantify the change in the merged firm's incentives to raise its prices or worsen its non-price offer (ie the change brought about by 'internalizing' the rivalry between the merger firms). In a market characterized by differentiated products, if firms are able to mark up prices substantially above their direct costs of sales, this suggests that the collective competitive pressure from rivals is relatively low because price-sensitive marginal customers of the firm would otherwise switch to these rivals and oblige the firm to lower its margins (by lowering its prices or increasing its non-price offer).<sup>75</sup>

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<sup>71</sup>Formally, the diversion ratio between Firms A and B is defined as the ratio of the elasticity of Firm B's demand to Firm A's price (ie the cross-price elasticity between Firms A and B) to the own-price elasticity of demand for Firm A (for further details of own- and cross-price elasticities, see footnote to paragraph 4.61).

<sup>72</sup>See, for example, [Anticipated acquisition by Co-operative Group Limited of Somerfield Limited](#), OFT, 20 October 2008.

<sup>73</sup>See, for example, [Completed acquisition by Tesco plc of five stores \(Thurso, Bedlington, Little Lever, Ramsbottom and North Hykeham\) from Somerfield plc](#), OFT, 19 December 2007.

<sup>74</sup>The value as evidence of the combination of gross margin data and diversion ratios is greatest where the acquiring firm continues to operate the acquired firm's brand(s) post-merger. For further details on the OFT's approach to using the combination of diversion ratios and gross margins in unilateral effects analysis, see [Anticipated acquisition of the online DVD rental subscription business of Amazon Inc. by LOVEFiLM International Limited](#), OFT, 15 April 2008.

<sup>75</sup>The extent to which costs can be said to vary 'directly' with the level sales will depend on the time horizon considered. Consequently, the ability of firms to mark up prices to a substantial degree over their 'direct' costs of sales in the short run need not suggest that the collective competitive pressure from rivals is relatively low if firms compete on longer-term parameters of competition, such as innovation. This is because the costs associated with these longer-term parameters may largely be fixed in the short term.

#### *Choice of alternative supplier*

- 4.105 Unilateral effects are more likely where customers have little choice of alternative supplier, whether because of the absence of alternatives or because of the level of switching costs (for example, in network markets—see paragraphs 4.181 to 4.184<sup>76</sup>).

#### *Rivals' reactions*

- 4.106 Unilateral effects are more likely where it is difficult for rivals to undercut price increases quickly, to expand to counter decreases in output or to react to a deterioration in quality (eg through product repositioning). Conversely, unilateral effects will be less likely where products are undifferentiated, and rivals of the merger firms have substantial spare capacity or can easily expand existing capacity. In this case, a rise in price initiated by the merged firm would simply encourage its customers to switch to supply from rivals.

#### *Competitive force in the market*

- 4.107 Unilateral effects are more likely where the merger eliminates an important competitive force in the market. For example, the merger may involve a recent entrant or a firm that was expected to grow into a significant competitive force or to otherwise provide a significant competitive threat to other firms in the market (eg by virtue of having a novel business model or a reputation for aggressive price cutting).

#### *Potential competition*

- 4.108 Unilateral effects may also arise from the elimination of potential competition. There are two ways in which the removal of a potential entrant could lessen competition by weakening the competitive constraint on an incumbent supplier:
- The first is where the merger prevents actual entry that would, or could, without the merger, have increased competition to above pre-merger levels. This can occur if a merger is between an incumbent and a firm which plans actual entry. This is sometimes referred to as 'actual potential competition'. Actual potential competition constrains the merged firm only if and when entry occurs.
  - The second is where the merger removes an existing constraint on the incumbent's behaviour imposed by the threat of entry. This is sometimes referred to as 'perceived potential competition'. Unlike the constraint from actual entry, which by definition has not arisen under pre-merger conditions, a constraint from perceived potential competition does exist in the pre-merger environment. Such competition gives an incentive to the incumbent to respond to this threat, for example by offering lower prices or more favourable non-price terms, partially to deter actual entry.
- 4.109 A merger could in principle eliminate both the potential for increased actual competition post-entry (actual potential competition) and the existing constraint posed by the threat of entry (perceived potential competition).

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<sup>76</sup>In 'multi-sided markets' (paragraphs 4.80 and 4.81) the Authorities may further consider any indirect constraint from customer behaviour on one side of the market to prices charged by the network/platform to customers on another side of the market.

### *Increased buyer power*

- 4.110 A merged firm will generally as a result of the merger enjoy greater buyer power than the merger firms could previously exert. In most cases, an increase in buyer power is not likely to cause detriment to consumers; at least some of the benefits to the firm from its greater buyer power can be expected to be passed on to its customers.<sup>77</sup>
- 4.111 However, in some circumstances, unilateral effects may arise from increased buyer power, causing harm to consumers. For example, consumers could be harmed if the merged firm has an incentive to lower the amount it purchases so as to reduce the purchase price it pays (known as ‘demand withholding’<sup>78</sup>) and it has sufficient market power over its customers that the quantity sold to them in the relevant market decreases, and the price at which it sells to them consequently increases.
- 4.112 Alternatively, buyer power might lead to suppliers having lower incentives to invest in new products and processes and therefore harm consumers by decreasing the number and quality of innovations.

### *Vertical effects of horizontal mergers*

- 4.113 Mergers that are principally horizontal in nature may have vertical effects if one or more of the merger firms also operates at a different level of the supply chain for a good or service.<sup>79</sup> If both merger firms act at more than one level of the supply chain, the merger may be characterized as a horizontal merger between two vertically-integrated firms.<sup>80</sup>
- 4.114 In assessing the vertical effects of a horizontal merger, the Authorities will use the same approach as in assessing a purely vertical merger (see further paragraphs 4.134 to 4.151). In particular, anti-competitive vertical effects will generally require there to be significant market power either upstream (for input foreclosure) or downstream (for customer foreclosure) post-merger. Therefore, in practice, in the case of a horizontal merger with vertical effects, only a degree of market power significant enough to give cause for concern over horizontal unilateral effects will typically give cause for concern over anti-competitive vertical effects.<sup>81</sup>

### **(d) Horizontal mergers—coordinated effects**

- 4.115 A merger may give rise to an SLC through coordinated effects. Firms operating in the same relevant market may recognize their mutual interdependence so that they can reach a more profitable outcome if they coordinate to limit their rivalry.
- 4.116 Coordination may take different forms. In many instances it will involve firms keeping prices higher than they would otherwise be in a more competitive market. However, coordination can in principle affect any competitive strategy, eg by limiting production or new capacity brought to the market. Firms may coordinate by dividing up the market between them, for example by geographic area or customer characteristics,

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<sup>77</sup>The extent to which any benefits accruing specifically to the merged firm from its increased buyer power are passed on to its customers does not depend solely on the degree of competition faced by the merged firm in the market (see paragraphs 4.195–4.198).

<sup>78</sup>See, for example, *Stonegate Farmers Limited/Deans Food Group Limited*, CC, April 2007.

<sup>79</sup>See, for example, *BOC Limited/Ineos Chlor Limited*, CC, December 2008.

<sup>80</sup>See, for example, *London Stock Exchange plc*, CC, November 2005.

<sup>81</sup>In horizontal mergers with vertical effects, the Authorities may have estimates of the extent to which prices might rise or non-price factors might worsen post-merger. If so, when considering the incentive of the merged firm to engage in input foreclosure at Phase 1, the OFT may assess whether partial or total input foreclosure is profitable on the basis of these estimates of increased price/worsened non-price factors post-merger.

or by allocating contracts in bidding competitions. However, coordination need not involve all competitive strategies that firms have at their disposal. Coordination can be explicit or tacit. Explicit coordination (achieved through communication and agreement between the parties involved) is likely to be a serious infringement of competition law. Tacit coordination (achieved through implicit understanding between the parties, but without any formal arrangement) is often, on the other hand, germane to an assessment of the effects of a merger.

4.117 The Authorities will examine whether, following the merger, conditions in the market are such that firms are or would become able profitably to coordinate their behaviour. A merger may give rise to an SLC if it makes coordination more likely or more effective.

4.118 All three of the following conditions must be satisfied for coordination to occur:

(a) Firms need to be able to reach and monitor the terms of coordination.

(b) Coordination needs to be *internally* sustainable among the coordinating group—firms have to find it in their individual interests to adhere to the coordinated outcome.

(c) Coordination needs to be *externally* sustainable, in that there is little likelihood of coordination being undermined by competition from third parties.

4.119 Two factors—cutting across the three conditions above—can be especially valuable in identifying the likelihood of a merger having coordinated effects:

(a) evidence of pre-existing coordination; and

(b) the role of concentration and symmetry.

#### *Evidence of pre-existing coordination*

4.120 There may be evidence to suggest that the market was already coordinated before the merger, implying that the three conditions were met pre-merger. For example, market outcomes pre-merger such as pricing and market share may be hard to reconcile with non-coordinated behaviour. Past cartel actions and proceedings in the same product market (in the UK or elsewhere) may also indicate that the conditions for coordination were met in that market.

4.121 If the Authorities determine that the pre-merger market showed coordinated outcomes, they will then consider whether the conditions for coordination have been strengthened or weakened as a result of the merger. In general, a merger in a market already showing coordinated outcomes would be likely to make coordination more sustainable or more effective, unless the structure and scale of the merged firm is so different from its predecessors' that the incentive to coordinate has been removed.

#### *The role of concentration and symmetry*

4.122 Coordination tends to be more likely in more concentrated markets. As the number of firms in the market falls, it becomes significantly easier to reach and monitor agreement. The incentives to sustain coordination will be higher with fewer firms in the market, as each firm is more likely to be detected if deviating from coordination and is more likely to take on the cost of punishing deviation. Consequently, measures of concentration can be valuable in assessing the likelihood that a merger will make

coordination more sustainable or more effective. For example, a merger that results in a market with two or three similarly sized firms, in which the three conditions for coordination are met (paragraph 4.117), may well be considered to give rise to an SLC on the basis of coordinated effects.

- 4.123 Coordination also tends to be more likely where there is greater symmetry of market shares between the coordinating firms, or more general similarities (for example, in terms of cost structures or the degree of vertical integration). Symmetry can make it easier to reach agreement as the firms' interests are more likely to be similar.<sup>82</sup> It can also improve internal sustainability. By contrast, in an asymmetric market, internal sustainability can be difficult. For example, it may not be in the interests of larger coordinating firms to retaliate, when faced with a small deviating rival, if this would eliminate profits from coordination in the market as a whole, and this lack of an incentive to retaliate can undermine coordination. Overall, therefore, mergers that result in more symmetric market outcomes are more likely to increase the probability of coordinated effects.<sup>83</sup>
- 4.124 Sometimes a merger may eliminate (or more rarely create) a firm that has substantially different incentives to coordinate than its rivals. Elimination of such a firm might significantly affect the likelihood of coordinated effects. For example, a firm might value having a reputation for the most competitive offer in the market, and would sacrifice profits in the long term if it were to lose that reputation by coordination. In some cases, as noted above, extreme asymmetries of market shares or other commercial characteristics between firms can result in one or more firms having particularly low incentives to coordinate. Whatever the cause of its behaviour, such a firm (sometimes termed a 'maverick') may be particularly disruptive to coordination and its elimination could therefore make coordination significantly more likely.
- 4.125 By contrast, coordination will tend to be less likely in markets that are inherently volatile and subject to change, for example where firms compete by investing in R&D to develop radically different products or production techniques. These innovations can bring about radical changes in market circumstances, making it difficult for the firms to converge on a coordinating strategy or to sustain the collusion because of strong incentives to deviate from any such strategy.

### *Three conditions for coordination*

#### *Ability to reach and monitor the terms of coordination*

- 4.126 For coordination to emerge, the firms involved need to reach a common understanding about its objectives (for example, a price below which they would not sell). Such an understanding need not involve explicit communication. For example, the coordinating price might emerge over time through repeated interaction.
- 4.127 So as to sustain coordination, firms will generally need to be able to monitor each other's behaviour sufficiently well that deviation from coordinated behaviour can be detected. Price transparency will typically assist such monitoring, but is not a necessary factor for coordination to be sustained. For example, a firm's knowledge of its own or competitors' sales volumes and capacities might provide enough information to determine whether or not deviation from coordinated behaviour is taking place.

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<sup>82</sup>Although the emergence of a 'market leader' might create an obvious price point on which to coordinate.

<sup>83</sup>See, for example, *DS Smith plc/LINPAC Containers Limited*, CC, October 2004.

- 4.128 The existence of significant structural links between firms in the market (such as being each other's customers or suppliers, holding cross-shareholdings or belonging to trade associations which can facilitate the exchange of information) may also assist in reaching and monitoring the terms of coordination.

*Internal sustainability*

- 4.129 Coordination will be sustained only if participating firms find it in their individual interests not to 'deviate' from the coordinated outcome, ie take advantage of their competitors' worsened competitive offers by competing aggressively to win increased sales. This will be the case if any deviating firm sees its profits reduced, so that it becomes rational for participating firms not to deviate. This 'deterrence mechanism' could simply be a reversion to normal competitive behaviour, rather than any deliberate strategy of 'punishment'.
- 4.130 The likelihood of coordinated effects arising will therefore depend on the efficacy of this mechanism, and its cost to the firms employing it. The deterrence mechanism will be more effective where monitoring of deviations is timely and accurate. It will also be more effective where the strategy followed is swifter and better targeted at harming the deviating firm. Coordination will therefore be more difficult to sustain in markets that are not transparent and where any deviation from a coordinated strategy cannot be identified for a long time.

*External sustainability*

- 4.131 Coordination will be sustained only if the outside competitive constraints on the firms involved in the coordination are relatively limited. It is not necessary for all firms in the market to be involved in coordination but those firms which coordinate need to be able collectively to exercise a degree of market power, in terms of the ability to increase profits by raising prices. As with unilateral effects, this will be less likely if existing competitors outside the coordinating group are likely to expand their sales in the face of such prices, or if the likelihood of new entry makes such prices unprofitable, or if customers are able to use their buyer power to undermine the collusion.
- 4.132 External sustainability will typically be easier where the non-coordinating firms currently in the market (the competitive 'fringe') are relatively weak and constrained in their ability to expand. Similarly, if barriers to entry are high, coordination is more likely to be sustainable.

**(e) Non-horizontal mergers**

- 4.133 Non-horizontal mergers can broadly be categorized as vertical mergers, conglomerate mergers or diagonal mergers. The following paragraphs discuss the effects of each type of non-horizontal merger on intra-market competition. (Non-horizontal mergers may also raise barriers to entry if they compel new entrants to enter at more than one level of the supply chain for a particular good or service, or to enter more than one market.)

*Vertical mergers*

- 4.134 Vertical mergers are mergers between firms that do not compete in the same relevant market but instead operate at different but complementary levels in the supply

chain for a particular good or service.<sup>84</sup> Vertical mergers are generally efficiency enhancing but some can give rise to an SLC.

- 4.135 Pure vertical mergers do not, in contrast with horizontal mergers, entail the loss of direct competition between firms in the same relevant market, and they are therefore less likely to lead to anti-competitive effects. Furthermore, the commercial rationale for vertical mergers often provides substantial scope for efficiencies leading to lower prices/better non-price offers to customers that benefit the merged firm (see paragraphs 4.206 to 4.212).
- 4.136 There are, broadly, two theories of harm for anti-competitive vertical effects: input foreclosure and customer foreclosure. In some circumstances, vertical effects may also arise if the merged firm gains access to commercially sensitive information about its non-integrated rivals.

#### *Input foreclosure*

- 4.137 Input foreclosure arises when the merged firm with upstream market power<sup>85</sup> raises the costs of its non-vertically-integrated downstream rivals by restricting their access to an important input, or by increasing the cost to them of that input.<sup>86</sup> An 'important' input means one that, if foreclosed, would adversely affect the competitiveness of the merged firm's rivals in the downstream market. Input foreclosure is therefore only anti-competitive if it significantly lessens competition in the downstream market.
- 4.138 Increasing the price or otherwise worsening the terms of access to the important input (eg reducing interoperability or quality) to its downstream rivals may result in the merged firm partially foreclosing them (ie raising their costs). Refusing access to the important input to its downstream rivals may result in the merged firm totally foreclosing them (ie forcing them to exit from the market).
- 4.139 In assessing the likelihood of input foreclosure, the Authorities will examine the ability and incentive of the merged firm to foreclose (partially or totally) its downstream rivals, and the effect of such foreclosure. In practice, these factors are closely linked.

- *Ability to foreclose input*

- 4.140 Anti-competitive input foreclosure will only be possible where it concerns an important input for the downstream product (as defined in paragraph 4.137). It will therefore be more likely where the merged firm has significant market power upstream.<sup>87</sup>
- 4.141 So as to assess the degree of market power upstream, the Authorities may have regard to the market share of the upstream merger party. Although they do not consider there to be any specific 'safe harbour' level of market share below which the existence of market power may be ruled out, an upstream market share of less than

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<sup>84</sup>When a firm supplies its products to a firm further down the supply chain which uses them as an input, the supplier is said to be an 'upstream' firm; the firm using the input is said to be a 'downstream' firm. For further discussion of 'upstream' and 'downstream' markets, see paragraph 4.6 and its second footnote, and paragraphs 4.74–4.76 and 4.82).

<sup>85</sup>The merged firm may have pre-existing market power in the case of a purely vertical merger, or it may have attained market power in the case of a principally horizontal merger with vertical effects.

<sup>86</sup>See, for example, *EWS Railway Holdings/Marcroft Engineering*, CC, September 2006.

<sup>87</sup>However, anti-competitive effects of input foreclosure can arise when the merged firm does not have upstream market power. If the upstream market contained just two competing firms producing undifferentiated inputs with plenty of spare capacity, it is possible that neither firm would have market power upstream. However, were one of the upstream firms to merge with a downstream firm that used the input and refuse to supply the input to its downstream rivals, the remaining downstream firms would face a monopoly input supplier upstream, ie the remaining non-integrated upstream supplier. The merger would then have created upstream market power.

30 per cent will not often raise concern over market power in relation to anti-competitive input foreclosure.<sup>88</sup>

- *Incentive to foreclose input*

4.142 The merged firm's incentive to engage in input foreclosure depends on whether foreclosure is profit-enhancing. Overall, this depends on the trade-off between the profit lost by the merged firm in the upstream market (because it sells less of its input to its downstream rivals) and the profit gained by the merged firm in the downstream market, because business diverts to the merged firm from the rivals, as a result of the rivals facing higher costs and being forced to raise their downstream prices (partial input foreclosure) or of being refused all supply and being forced to exit from the market (total input foreclosure).

4.143 In assessing this trade-off, the Authorities may therefore take into account:

- the merged firm's profit margins upstream, particularly on sales to rival downstream companies;
- the volume of upstream business that moves from the merged firm to its upstream rivals as it sells less of the input downstream;
- the ability and incentive for upstream rivals to raise prices of—or refuse to supply—the input to downstream customers;
- the merged firm's post-merger profit margins downstream (recognizing that the vertical merger may mean that the merged firm's variable cost and price downstream are reduced);
- the extent to which downstream rivals of the merged firm increase their prices or otherwise worsen their competitive offers in response to the merged firm's input foreclosure; and
- the volume of business that consequently moves downstream to the merged firm from its rivals;

- *Effect of input foreclosure*

4.144 Even if one or more downstream firms are denied access to the input, or face a higher price for it, competition in the downstream market is not necessarily substantially lessened nor are consumers necessarily adversely affected. The Authorities will therefore also consider the likely effects of any input-foreclosing strategies on competition and the competitive offering to final customers. Relevant factors in this assessment include:

- the nature of competition upstream and downstream;
- the way in which input prices are established, and the structure of these prices; and

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<sup>88</sup>The merged firm may have pre-existing upstream market power in the case of a purely vertical merger, or it may have attained upstream market power in the case of a principally horizontal upstream merger with vertical effects downstream. The 30 per cent market share screen applies to the former case. In the latter case, the Authorities will assess the degree of market power upstream that the merger confers on the merger firms and will use this to assess the merged firm's ability to input-foreclose, rather than simply examining whether its upstream market share is less than 30 per cent.

- whether there is double marginalization<sup>89</sup> pre-merger, which the merger removes, thus leading to reduced prices to customers.<sup>90</sup> (The Authorities will consider other efficiencies as part of the assessment of relevant customer benefits—see paragraphs 4.200 to 4.220).

4.145 In practice, if the OFT—in its role as a first screen in merger control—concludes that there is a realistic prospect that the merged firm will have the ability and incentive to engage in input foreclosure, it may presume that such foreclosure will also have an adverse effect. However, this presumption may be rebutted if there is clear evidence to the contrary. By contrast, the CC—as the determinative body in merger control role—will instead assess what would be the likely adverse effect of a profit-enhancing customer foreclosure strategy.

#### *Customer foreclosure*

4.146 Customer foreclosure arises when the merged firm with market power raises the costs of its non-vertically-integrated upstream rivals by restricting their access to important customers, or by increasing the cost to them of their access to those customers. Important customers are those who, if foreclosed, would adversely affect the competitiveness of the merged firm's rivals in the upstream market. Customer foreclosure is therefore only anti-competitive if it significantly lessens competition in the upstream market.

4.147 Increasing the price or otherwise worsening the terms of access to customers to its upstream rivals may result in the merged firm partially foreclosing them (ie raising their costs). Refusing access to customers to its upstream rivals may result in the merged firm totally foreclosing them (ie forcing them to exit).

4.148 In assessing the likelihood of customer foreclosure, the Authorities will examine the ability and incentive of the merged firm to foreclose (partially or totally) its upstream rivals, and the effect of any such foreclosure. In practice, these factors are closely intertwined.

4.149 The Authorities' approach to analysing the ability, the incentive and the effect of customer foreclosure is similar to that for input foreclosure. In particular, customer foreclosure will only be possible where it concerns an important route to market, and will be more likely where the merged firm has significant market power downstream.<sup>91</sup> The merged firm will only have the incentive to engage in customer foreclosure where it is profit enhancing—that is, where the profit gained by the merged firm in the upstream market exceeds the profit lost by the merged firm in the downstream market. In assessing this trade-off, the Authorities may therefore take into account:

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<sup>89</sup>Double marginalization is discussed in the section on *Efficiencies* below (paragraphs 4.200–4.220). It occurs where the upstream firm and downstream firm both try to extract a mark-up pre-merger which is not in their jointly profit-maximizing interest post-merger. The merged firm can 'internalize' the incentives, leading to more of the output being sold downstream and to lower downstream prices.

<sup>90</sup>Although it may be the case that such pricing efficiencies could be achieved without the merger, for example by contracting, it may also be the case that input foreclosure could be achieved without the merger through contracting, and thus that the merger could have no anti-competitive effect. The Authorities will need strong evidence for such claims before reaching a conclusion.

<sup>91</sup>The merged firm may have pre-existing downstream market power in the case of a purely vertical merger, or it may have attained downstream market power in the case of a principally horizontal downstream merger with vertical effects upstream. In the former case, although the Authorities do not consider there to be any specific 'safe harbour' level of market share below which the existence of market power may be ruled out, a downstream market share of less than 30 per cent will not often give cause for concern over market power leading to anti-competitive customer foreclosure. In the latter case, the Authorities will assess the degree of market power downstream that the merger confers on the merger firms and will use this to assess the merged firm's ability to customer-foreclose, rather than simply examining whether its downstream market share is less than 30 per cent.

- the merged firm's profit margins downstream, particularly on purchases from rival upstream companies;
- the volume of downstream business that moves from the merged firm to its downstream rivals when it purchases less upstream;
- the ability and incentive for downstream rivals to raise the price of—or refuse access to—the route to market to upstream suppliers;
- the merged firm's post-merger profit margins upstream (recognizing that the vertical merger may mean that the merged firm's variable cost and price upstream are reduced);
- the extent to which upstream rivals of the merged firm increase their prices or otherwise worsen their competitive offers in response to the merged firm's customer foreclosure; and
- the volume of business that consequently moves upstream to the merged firm from its rivals.

4.150 As with input foreclosure (paragraph 4.145), the OFT may presume that sufficient ability and incentive on the part of the merged firm will lead to adverse effects, unless this presumption can be rebutted. By contrast, the CC will instead assess what would be the likely adverse effect of a profit-enhancing customer foreclosure strategy.

#### *Other anti-competitive effects*

4.151 Vertical mergers may give rise to other anti-competitive effects, not discussed above. They may, notably, allow the merged firm to gain access to commercially sensitive information about the upstream or downstream activities of non-integrated rivals, allowing it unilaterally to compete less aggressively in the downstream market or to otherwise put rivals at a competitive disadvantage.<sup>92</sup> Less commonly, a vertical merger may have the effect of restoring upstream monopoly power; this could occur where a monopoly input supplier could not extract high prices from downstream firms before a merger because it could not credibly commit not to supply their competitors; a vertical merger between the monopoly input supplier and its customer could make this commitment credible.

#### *Conglomerate mergers*

4.152 Conglomerate mergers are those between firms in different relevant markets that are not vertically related. These firms may produce closely-related products which they sell largely to the same customers (that is, mergers between firms producing complementary products), or they may produce completely unrelated products.

4.153 Conglomerate mergers do not entail the loss of direct competition between firms in the same relevant market and are therefore less likely than horizontal mergers adversely to affect competition. Furthermore, the commercial rationale for conglomerate mergers of complementary products may provide substantial scope for efficien-

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<sup>92</sup>See, for example, [BSkyB/ITV](#), CC report sent to the Secretary of State (BERR), December 2007.

cies leading to lower prices/better non-price offers to customers that benefit the merged firm.<sup>93</sup>

- 4.154 In broad terms, there are two theories of harm for anti-competitive conglomerate effects, both of which are types of foreclosure: foreclosure through tying or bundling, and foreclosure through portfolio effects.

#### *Foreclosure through tying and bundling*

- 4.155 Tying and bundling may enable the merged firm to use its market power in one market to foreclose competitors in another by employing selling practices that link the products (A and B, say) in the separate markets together.<sup>94</sup> With tying, this occurs when customers can purchase product A (the tying product with market power) only together with product B (the tied product). With bundling, this occurs when customers receive discounts or rebates for purchasing both product A and B.<sup>95</sup> While foreclosure through tying and foreclosure through bundling differ in form, they are substantially the same in effect.

#### *Foreclosure through portfolio effects*

- 4.156 Portfolio effects, a related form of foreclosure, may arise if customers value variety (rather than valuing one, or a few, key tying products) and wish to purchase both A and B. In this case, a conglomerate merger may give the merged firm a product range advantage that can lead to increased market power for its portfolio of products.

#### *Assessment of foreclosure*

- 4.157 An SLC will only result from a conglomerate merger if the foreclosure, whether through tying, bundling or portfolio effects, significantly lessens competition in the affected market(s) (referred to as anti-competitive foreclosure).

- 4.158 In assessing the likelihood of anti-competitive foreclosure through tying or bundling, or anti-competitive foreclosure through portfolio effects, the Authorities will examine the ability and incentive of the merged firm to foreclose its rivals, and the effect of any such foreclosure. In practice, these factors are closely linked.

- *Ability to foreclose*

- 4.159 Anti-competitive foreclosure by tying or bundling will generally be more likely where the merged firm has significant market power in at least one of the markets involved, for example if at least one of the merged firm's products is viewed by many customers as important with few relevant alternatives.

- 4.160 Similarly, anti-competitive foreclosure by portfolio effects will generally be more likely where there are substantial fixed costs associated with providing the variety that

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<sup>93</sup>This may particularly be the case where the complementarity between the products is symmetric—that is, each is equally complementary to the other. However, this need not be the case where the complementarity between the products is asymmetric—that is, one product is a complement to the other but the converse is not true (for a discussion of this, see the report on the market investigation into [Payment protection insurance](#), CC, January 2009).

<sup>94</sup>The Authorities' analysis of foreclosure through tying and bundling may therefore be closely linked to market definition for mergers involving secondary product markets, where the products in the primary and the secondary markets are complements (see further paragraphs 4.80 and 4.81).

<sup>95</sup>Pure bundling occurs when consumers cannot buy products A and B separately; mixed bundling occurs when they can. Generally, the difference between tying and pure bundling is divisibility: a tie that requires (say) two units of product B to be sold for every unit of product A is not the same as a pure bundle containing four units of B and two of A.

customers value and few, if any, other firms are capable of matching the merged firm's portfolio.

4.161 Foreclosure through both tying/bundling and portfolio effects will generally be more likely where there is a large pool of shared customers for the products (for instance, if the products are complementary) and where the merged firm can credibly commit to tying or bundling or to only supplying its full portfolio.

- *Incentive to foreclose*

4.162 The merged firm's incentive to engage in conglomerate foreclosure depends on whether it is profit enhancing. This in turn depends on the trade-off that the merged firm faces between the possible costs from foreclosure and the possible gains from expanding market shares in the markets concerned or from raising prices in those markets.

4.163 For example, the merged firm may have an incentive to tie a complement to its product if there is a substitute for its tying product that limits its pricing power: in this way, the merged firm may see a gain in profit from foreclosure in the tying market in terms of raising prices. Alternatively, the merged firm may have an incentive to tie a complement to its product so as to see a gain in profit from foreclosure in terms of increased market share in the tied market. Set against these incentives, if a substantial proportion of customers for the tying product prefer to buy it in isolation, sales of the tying product as part of the bundle may be expected to fall, reducing the merged firm's incentives to engage in foreclosure.

- *Effect of foreclosure*

4.164 In assessing the effect of foreclosure through conglomerate effects, the Authorities will have regard in particular to demand-side pricing efficiencies. For example, individual producers of complementary goods will price them independently, whereas a single producer may take into account the positive effect of a reduction in the price of one product on sales of its complement. A conglomerate merger may therefore give the merged firm the incentive to lower prices.<sup>96</sup> (The Authorities will consider other efficiencies as part of its assessment of relevant customer benefits—see paragraphs 4.200 to 4.220.)

4.165 In practice, if the merged firm is found likely to have the ability and incentive to foreclose, the OFT may presume that such foreclosure will have anti-competitive effects, unless that presumption can be rebutted. By contrast, the CC will assess what would be the likely adverse effect of a profit-enhancing foreclosure strategy.

*Other relevant considerations in foreclosure theories*

4.166 When assessing the incentives of the merged firm to engage in foreclosure, the gains and losses from foreclosure that could have been measurable before the merger may give only an approximate measure post-merger.<sup>97</sup> Moreover, the change in the merged firm's incentives to engage in foreclosure after the merger presupposes a

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<sup>96</sup>Depending on how symmetric the complementarity is between the bundled products (see previous footnote). Moreover, lower prices are likely to be offered by the merged firm to those customers who buy the bundle of products, but this need not mean that average prices fall.

<sup>97</sup>For example, because of the internalization of the double mark-up following a vertical merger, or of the pricing externality between complements following a conglomerate merger; or depending whether the merged firm's foreclosure strategy is partial or total.

change in the competitive strategy formerly adopted by the merger firms. Both factors may complicate the Authorities' assessment of foreclosure.

- 4.167 In certain situations, foreclosure may involve behaviour that is unlawful under competition law. In assessing this, the Authorities may take into account whether the behaviour would be clearly, or highly probably, unlawful; whether the behaviour would be likely to be detected; and whether it would be likely to be rectified (eg by penalties imposed by the OFT) in a timely manner.

### *Diagonal mergers*

- 4.168 A diagonal merger is a special type of vertical merger. A diagonal merger could, for example, be between an upstream firm that supplies an input to its downstream subsidiary and a rival of that downstream subsidiary that does not use the input. An increase in the price of the input may therefore increase demand for the rival downstream output. The diagonal merger internalizes this rivalry and may give the merged firm the incentive to raise the price of the input and of the rival downstream output, provided (a) the input is an important component of the output, (b) the merger firm has market power in the input and (c) the rival output competes closely with the merger firm's output. A diagonal merger also offers less scope for pricing efficiencies than a vertical merger. For this reason, diagonal mergers are closer in their impact on competition to horizontal mergers than they are to vertical mergers. Therefore, although many diagonal mergers may be benign, the Authorities do not assume that they are.

### *Coordinated effects arising from non-horizontal mergers*

- 4.169 Non-horizontal mergers, like horizontal mergers, may create or strengthen coordinated effects. Vertical mergers may do this in several ways. For example, a vertical merger may allow the merged firm to gain access to commercially sensitive information about the upstream or downstream activities of non-integrated rivals; this can facilitate coordination.
- 4.170 Further, a vertical merger that results in foreclosure will reduce the number of players in the market making it easier for the remaining players to coordinate. A vertical merger may also increase the level of symmetry (eg in costs, if other firms in the market also are vertically integrated) and/or transparency in the market (eg by giving upstream producers control of downstream prices), making it easier to reach and monitor a coordinated outcome.
- 4.171 In addition, a vertical merger may better align the incentives of firms in the market to maintain coordination (eg by enabling the vertically integrated firm to punish deviation more effectively if it becomes an important supplier to, or customer of, other firms in the market after the merger). And a vertical merger may increase barriers to entry, which can reduce the scope for entry to disrupt coordination, or reduce buyer power if it involves the acquisition of a customer who would otherwise disrupt coordination.
- 4.172 Conglomerate mergers may also create or strengthen coordinated effects in several ways. For example, they may strengthen the incentives to coordinate by enhancing the ability to agree on the collusive outcome, by increasing the scope of punishment and by increasing the ability to detect deviations. Foreclosed rivals may choose not to contest the situation of coordination, but may prefer instead to benefit from the increased price level.

4.173 In addition, conglomerate firms may compete against each other in multiple markets. Where firms interact frequently, across multiple markets, they may be more likely to be able to develop coordinating strategies. Deviation from the coordinated outcome in one market can be punished in another market, where the punishment hurts more, or in all markets. As the number of markets affected by the merger increases, the information available on market conditions also increases and detection of deviation may become easier. A conglomerate merger, which increases contact between rivals in multiple markets, may therefore enhance the likelihood of coordination.

***(f) Barriers to entry and expansion***

4.174 In some cases, entry and/or expansion may be sufficient to deter or defeat any attempt by the merged firm (and its competitors) to exploit any reduction in competitive rivalry resulting from the merger. For this to be the case, entry and/or expansion must be shown to be timely, likely and sufficient to act as a competitive constraint.

4.175 Entry and expansion may take several forms including: entry of new firms either by building new capacity or expanding the market, or by taking over existing capacity and using it in new, or more productive, ways; entry as a result of new technology facilitating new production methods; entry by firms in related markets through forward or backward integration; and expansion of the market by existing firms building new capacity.<sup>98</sup>

4.176 Potential (or actual) competitors may encounter barriers which adversely affect the likelihood, timeliness and sufficiency of their ability to enter (or expand in) the market. Barriers to entry are thus specific features of the market, which give incumbent firms advantages over potential competitors. Where entry barriers are low, the merged firm is more likely to be constrained by entry; conversely, this is less likely where barriers are high. The strength of any given set of barriers to entry or expansion will to some extent depend on characteristics of the market such as demand growth.

*Types of barriers to entry and expansion*

4.177 Types of barriers to entry or expansion, including those that can be classified into broad categories, are described below. Where entry or expansion takes different forms, the Authorities will consider the different types of entry barriers associated with each form of entry so as to examine whether such entry and/or expansion would be a sufficient competitive constraint on the merged firm (and its competitors).

*Absolute advantages*

4.178 Absolute advantages include legal and technical advantages. Legal advantages include government regulations that limit the number of market participants (by, for example, restricting the number of licences granted), and tariff and non-tariff trade barriers. Current market players may also enjoy technical advantages, such as preferential access to essential facilities or intellectual property rights, which make it difficult for any new entrant to compete effectively.

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<sup>98</sup>Entry and supply-side substitution are therefore closely related. Essentially the difference between them is one of cost and timeliness: supply-side substitution is near costless and short term (ie generally less than one year). See further paragraph 4.70.

### *Intrinsic/structural*

- 4.179 Intrinsic/structural advantages arise from the technology, production methods or other factors necessary to establish an effective presence in the market. They include initial set-up costs, costs associated with investment in specific assets, research and advertising. Such costs are more likely to deter entry or expansion where a significant proportion of them are sunk, ie the costs cannot be recovered when exiting from the market. The cost of exiting from the market is also a significant risk factor that may deter entry.

### *Economies of scale*

- 4.180 Economies of scale arise where average costs fall as the level of output rises. Economies of scale can mean that small-scale entry will not act as an effective competitive constraint in the market. Furthermore, a new entrant may be deterred from entering on a large scale, because of the risks involved in entry, especially where entry costs are sunk. Large-scale entry or expansion will generally be successful only if the firm can expand the total market significantly, or substantially replace one or more existing firms.

### *Strategic advantages*

- 4.181 Strategic advantages arise where incumbent firms have advantages over new entrants because of their established position (sometimes called ‘first-mover advantages’). For example, it may be difficult to enter a market because experience or reputation is necessary to compete effectively, both of which may be difficult to obtain as an entrant. Other relevant factors include loyalty to a particular brand and the closeness of relationships between suppliers and customers. Incumbent firms may also behave strategically in responding to entry, for example by lowering prices or by investing in additional capacity or additional brands to deter entry.
- 4.182 Such barriers to entry may be particularly high in markets with network effects. Network effects arise when services are provided over a network (eg in the case of telecommunications or transportation) or through a platform (eg in the case of a website). In some cases, these network effects arise because the larger the number of customers connected to the network, or with access to the platform, the more highly customers value the network or platform. Network effects can thus arise within one group of customers.<sup>99</sup>
- 4.183 In other cases, in multi-sided markets where firms serve different and unrelated groups of customers (eg advertisers and viewers, listeners or readers in the case of media markets), these network effects arise because the more there is of one group of customers with access to the network or platform (eg viewers, listeners or readers), the greater is its value to other groups of customers (eg advertisers). Network effects can thus arise from one group of customers to another. However, such network effects need not be mutually reinforcing (eg viewers, listeners or readers may prefer fewer advertisements and more content).<sup>100</sup>
- 4.184 Network effects—within or between groups of customers—can make the market prone to ‘tipping’. That is, as one firm, or technology, gains an advantage in the market, the balance of power in the market in effect ‘tips’ in its direction leaving it as the unassailable leader. This may create switching costs for the existing customers,

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<sup>99</sup>See, for example, *London Stock Exchange plc*, CC, November 2005.

<sup>100</sup>For further discussion of network effects in multi-sided markets, see paragraphs 4.80 and 4.81, 4.97, 4.191 and 4.215–4.217.

and often means that in the presence of one network it may not be possible for a network configured in a different way to be viable. In markets characterized by network effects, a likely entrant will need to take the risk of developing new infrastructure but may not succeed in creating the necessary demand so as to make the development of a new network profitable.

### *Customer switching*

- 4.185 The Authorities will consider whether or not customers would be willing to switch to a new supplier. Customers' willingness will depend on the costs and benefits to them of switching, and factors the Authorities may therefore take into account are: the cost of switching, brand loyalty, the length of existing contracts and the closeness of relationships between suppliers and customers. In addition, customers may be willing to sponsor and/or facilitate new entry (see further paragraphs 4.191, 4.195 and 4.196).

### *Likelihood of entry or expansion*

- 4.186 The Authorities examine not only the extent of any barriers to entry that may impact on the likelihood of entry but also whether firms intend to enter the market. For example, in a market characterized by low barriers to entry and/or expansion, entrants may nevertheless be discouraged from entry by the small size of the market, or the threat of retaliation by incumbents (whether in the same market as the merged firm or another where that new entrant is already present).
- 4.187 New entry or expansion and the threat of it can represent important competitive constraints on the behaviour of the merged firm. If entry or expansion is particularly easy and likely, the mere threat of entry or expansion may be sufficient to deter the merged firm from raising its prices since any price increase or reduction in output/quality would incentivize that new entry or expansion to take place. In assessing the likelihood of post-merger entry, the Authorities will evaluate whether entry is likely to take place at pre-merger prices. The reason for this is that the objective of entry analysis is to assess whether entry is likely to prevent prices from rising following the merger; the only entrant who would be able to constrain prices to pre-merger levels are those who would find it profitable to operate in the market at pre-merger prices.

### *Scope of entry*

- 4.188 To be considered a competitive constraint, entry or expansion should be of sufficient scope to deter or defeat any attempt by the merged firm to exploit any reduction in competitive rivalry resulting from the merger. A small market share (compared with the increment in market share arising from the merger) may be deemed sufficient to prevent an SLC for undifferentiated goods where there are no barriers to further expansion. By contrast, small-scale entry by a producer of differentiated goods may be insufficient, even when the entry may be the basis for later expansion. For example, entry into some market niche may be possible, but the niche product may not necessarily compete strongly with other products in the overall market and so may not constrain incumbents effectively.

### *Timeliness of entry*

- 4.189 Entry must also be considered sufficiently timely and sustained to constrain the merged firm. Entry or expansion within less than two years will generally be timely, but this is assessed on a case-by-case basis, depending on the characteristics and dynamics of the market, as well as on the specific capabilities of potential entrants.

### *Assessment of entry/expansion*

4.190 In assessing whether entry and expansion might act as an effective competitive constraint on the merged firm, the Authorities will typically gather information on several relevant factors:

- the history of past entry or expansion; this will include a consideration of the costs of such entry, how long any entrants traded in the market and the effects that entry or expansion had on competition in the market—in particular, whether past entry or expansion modified the pattern of behaviour and competition;
- evidence of planned entry or expansion by third parties;
- direct observations, or statistical information, on barriers to entry, expansion and exit;
- the costs involved in entry or expansion and in operating at the minimum efficient scale necessary to achieve a reasonably competitive level of costs (and consequently any cost disadvantage from operating below the minimum efficient scale);
- the period of time over which costs of entry or expansion might be recovered so as to assess whether entry or expansion will be profitable (at pre-merger prices);
- the existence of long-term contracts;
- the cost of exiting from the market (so as to establish if the costs of entering the market are so large and sunk that they cannot be recovered upon exit);
- the potential effect of technological change and innovation on barriers to entry or expansion;
- the ability and incentive of customers to sponsor entry or expansion in the relevant market(s);
- the possibility of imports or supply-side reactions to the extent that these have not already been taken into account in identifying participants in the relevant market, for example because they would not occur quickly enough to be classed as such; and
- the likely response to entry or expansion by incumbent firms.

### *The effect of the merger on new entry/expansion*

4.191 The Authorities will also consider how the merger may affect the possibility and/or likelihood of new entry or expansion. The merger may increase barriers to entry and/or expansion by, for example, allowing the merged firm to benefit from positive network effects, strengthening its incumbency advantage in a network market (see paragraphs 4.182 to 4.184). The merger may also reduce or eliminate an important competitive constraint by the removal of a potential entrant. This would particularly be the case where the merger firms compete in several related markets. In such cases, a merger could reduce the potential for entry or expansion in the markets in which one of the two merger companies is not currently present. A larger merged firm might be perceived to increase the risk involved in entry or expansion by potential new entrants or existing competitors since, arguably, the larger the firm, the more it might be expected to defend its position in the market.

### ***(g) Countervailing buyer power***

- 4.192 An individual customer will have countervailing buyer power where the ability of a merged firm to lower the competitiveness of its offer, for example by raising prices, is limited by the negotiating strength of that customer. If all customers of the merged entity possess countervailing buyer power post-merger, this is likely to alleviate any adverse effects resulting from a merger. However, often only some—not all—customers of the merged entity possess countervailing buyer power. In such cases, the Authorities assess the extent to which the countervailing buyer power of these customers may be relied upon to protect all customers.
- 4.193 Buyer power can be generated by different factors. An individual customer's negotiating position will be stronger if it can easily switch its demand away from the supplier, or where it can otherwise constrain the behaviour of the supplier.
- 4.194 Typically the ability to switch away from a supplier will be stronger if there are several alternative suppliers to which the customer can credibly switch, or the customer has the ability to sponsor new entry or enter the supplier's market itself by integrating upstream. Where customers have no choice but to take a supplier's products, they may still be able to constrain prices by imposing costs on the supplier. For example, customers may be able to refuse to buy other products produced by the supplier, or, in the case of a retailer, position the supplier's products in less eye-catching parts of the shop.
- 4.195 Even where the market is characterized by customers who are visibly larger than the suppliers, it does not necessarily follow that there will be countervailing buyer power. The Authorities assess whether and to what extent the merger is likely to reduce the customer's ability and incentive to pursue credibly any of the strategies set out in the preceding paragraphs. It is possible, for example, that a merger may reduce a customer's ability to switch or even to sponsor new entry and, if this reduction adversely affects the negotiating position of a customer significantly, that customer's buyer power will not be sufficient to be countervailing.
- 4.196 Where a supplier is engaged in bilateral negotiations with each of its customers, the relative bargaining strength of the supplier and each of its customers is determined by their mutual dependency. In such situations it may be easier for large customers to threaten to sponsor new entry or integrate upstream than it would be for smaller customers who could not commit a sufficiently large volume of purchases to make either viable. Conversely, small buyers may be in a better position to switch suppliers because of the lower volume of their purchases.
- 4.197 The extent to which the buyer power of one customer, or group of customers, can constrain the merged firm (sometimes referred to as the 'umbrella effect') will depend on the market concerned. Where individual negotiations are prevalent, the buyer power possessed by any one customer will not typically protect other customers from any adverse effect that might arise from the merger.
- 4.198 In the rarer cases where there are no bilateral negotiations between suppliers and customers, and the price of the input is determined via a market mechanism which is transparent to all suppliers and customers, buyer power may arise simply because of a buyer's size. In these cases, the buyer power of one or more customers may act to protect other customers with less or no buyer power by preventing a rise in the price ultimately paid by all customers.
- 4.199 The Authorities do not consider that the mere existence of buyer power before the merger is sufficient to show that countervailing buyer power alleviates any of a

merger's adverse effects. The buyer power must remain effective following the merger and the Authorities will need to assess whether or not that is the case. They will consider, for example, if the reduced number of credible suppliers in a market will reduce any countervailing buyer power.

## **(h) Efficiencies**

- 4.200 While mergers can harm competition, they can also give rise to efficiencies that can be passed on to customers. Such efficiencies may broadly be characterized as supply side (such as cost savings) or demand side (such as increased network size). The Act allows the Authorities to take any efficiency gains arising from a merger into account at two separate points in the analytical framework.
- 4.201 First, efficiencies may be taken into account where they benefit customers and prevent a merger giving rise to an SLC. Second, efficiencies may also be taken into account where they do not prevent an SLC but nonetheless outweigh it to the benefit of customers. In this case, the OFT may apply its 'relevant customer benefits' exception to the duty to refer the merger to the CC (see paragraph 2.6). The CC may, in any case, subsequently have regard to preserving such relevant customer benefits as part of its process for remedying or mitigating the anti-competitive effects of the merger (see paragraph 6.12 of these guidelines and paragraphs 1.14 to 1.20 of [Merger Remedies: Competition Commission Guidelines, CC8](#)).
- 4.202 The following paragraphs discuss the Authorities' approach to considering efficiencies and list examples of possible supply- and demand-side efficiencies.

### *Approach to assessing efficiencies*

- 4.203 As discussed in paragraphs 4.3 to 4.5, a merger may be expected to lead to an SLC when it harms customers by, for example, driving up prices or costs or by decreasing output, innovation, productivity or product quality. Efficiencies from a merger that prevent these adverse effects therefore prevent the merger giving rise to an SLC.
- 4.204 For claimed efficiency gains to be taken into account in applying the SLC test, they must meet the following cumulative criteria:
- Efficiencies must be demonstrated to be very likely to arise, and to do so within a period of time corresponding to the onset of any potential adverse effects on customers.
  - Efficiencies must be merger specific, ie a direct consequence of the merger, judged relative to what would happen without it.
  - The benefits of efficiencies must be passed on (wholly or partially) to customers of the merged firm.<sup>101</sup> It is sometimes claimed that firms will only have an incentive to pass on efficiencies in a competitive market. The Authorities' view is that this incentive will depend primarily on the demand characteristics facing the merged firm, which will need to be assessed on a case-by-case basis.
- 4.205 Efficiency claims can be difficult for the Authorities to verify because most of the information concerning efficiencies is held by the merger parties. The Authorities will

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<sup>101</sup>Efficiencies that benefit other customers or arise in other markets (provided that they are passed on, wholly or partially, to customers) may nonetheless fall for consideration as relevant customer benefits.

therefore require the merger parties to provide strong evidence to support any efficiency claims. Provided that the evidence the parties present on efficiencies is compelling, the Authorities will have regard both to the likelihood of the benefits materializing and the magnitude of those benefits in weighing them against the magnitude and likelihood of adverse effects.

### ***Supply-side efficiencies***

4.206 In broad terms, supply-side efficiencies arise if the merged firm can supply its products at lower cost as a result of the merger. Common examples of supply-side efficiencies are each described below: cost reductions, the removal of double marginalization in vertical mergers, aligning incentives within a vertically-merged firm to invest in new products, processes, marketing etc (known as solving the 'investment hold-up' problem), and product repositioning.

#### *Cost reductions*

4.207 There are several ways in which horizontal, vertical and conglomerate mergers may give rise to efficiencies in the form of cost savings. For example:

- The merged firm may benefit from economies of scale (from having a larger scale of operations) or economies of scope (eg from the joint supply of different products). Either of these can also produce reductions in fixed costs.
- The merged firm may be able to benefit, across its portfolio of products, from the more efficient production processes or working methods of one of the merger firms.
- Vertical mergers may improve the coordination of upstream production and downstream distribution, leading to lower transaction and inventory costs.

4.208 The Authorities are more likely to take cost savings into account where efficiencies reduce marginal (or short-run variable) costs as these tend to stimulate competition and are more likely to be passed on to customers in the form of lower prices, given their importance in firms' short-run price-setting behaviour. The Authorities will not in general give as much weight to savings in fixed costs because they may often represent private gains to firms and are less important in short-run price formation, although reductions in fixed costs may play an important role in longer-term price formation.

#### *Removal of double marginalization*

4.209 Vertical mergers may allow the merged firm to remove ('internalize') any pre-existing double mark-ups (see also paragraph 4.144). These arise when, pre-merger, the upstream and downstream firms set their prices independently and both charge a mark-up, resulting in end prices to consumers being higher than suits the joint interests of both firms. A vertical merger may enable and provide incentives for the merged firm to internalize this double mark-up resulting in a decrease in the price of the output in the downstream market. This efficiency is known as the removal of double marginalization.<sup>102</sup>

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<sup>102</sup>For a fuller definition, see second footnote to paragraph 4.144.

4.210 However, in some cases double mark-ups may not be significant pre-merger. This may be the case, for example, if existing vertical supply agreements include a price mechanism with volume discounts which eliminate the mark-up.

#### *Solving the 'investment hold-up' problem*

4.211 An additional supply-side efficiency that may arise in vertical mergers results from aligning the incentives upstream and downstream within the merged firm to invest in new products, processes, marketing etc. For example, a downstream distributor of an upstream firm's products may be reluctant to invest in promoting those products because its investment may also benefit competing distributors. A vertical merger can alleviate this 'investment hold-up' problem.

#### *Product repositioning*

4.212 Some mergers of producers of differentiated products may result in the merged firm and its rivals repositioning (or 'rebranding') their products after the merger. The merger firms may seek to reduce the cannibalization between the merger firms' products by increasing the differentiation between them. Their rivals may then reposition their products between those of the merger firms. If so, post-merger product repositioning increases variety, and this benefits customers.

4.213 Repositioning may also have two countervailing effects on prices: it reduces the substitutability between the merging products, mitigating post-merger price increases; but it also softens price competition generally as product varieties 'spread out'.

4.214 In general, the Authorities require compelling evidence to demonstrate efficiencies. The overall effect of product repositioning is particularly difficult to establish because the sum of any benefits to customers will be determined by increased variety plus the net effect of product repositioning on prices.

#### ***Demand-side efficiencies***

4.215 In broad terms, demand-side efficiencies arise if the attractiveness to customers of the merged firm's products increases as a result of the merger. Common examples of demand-side efficiencies include network effects, pricing effects and 'one-stop shopping'.

#### *Network effects*

4.216 As explained in paragraphs 4.182 to 4.184, network effects arise when services are provided over a network (eg in the case of telecommunications or transportation) or through a platform (eg in the case of a website) where firms serve different and otherwise unrelated groups of customers.

4.217 A merger may enhance network effects of both types. Where there are network effects within one group of customers, to the extent that a merger enhances them, this will benefit all customers. However, where network effects are from one group of customers to another, a merger may benefit some customers but adversely affect others.

## *Pricing effects*

- 4.218 Demand-side efficiencies may arise in a conglomerate merger when the merger firms' products are complements rather than substitutes, so that lowering the price of one product increases demand for it and for other products that are used with, and not instead of, it (see paragraph 4.153). Bringing products that are complements under common ownership may allow the merged firm to obtain the positive effect of a fall in the price of one on sales of the others. Achieving this effect through a merger may result in lower prices for all products in the bundle, because it may become profit enhancing for the firm which sells all the complements to sell them at a lower combined price than the sum the customer would have paid to assemble the same package from several different suppliers before the merger.<sup>103</sup>
- 4.219 The extent of any possible pricing efficiency post-merger will depend on the dynamics of the market pre-merger. If pre-merger prices were competitively set, there is little scope for the price to go down post-merger. In addition, any failure to exploit pricing complementarities may not be significant pre-merger. This may be the case if the pricing of the complementary products is not on a simple 'per unit' basis but instead involves (say) a fixed component and some per-unit price that varies with the quantity bought. Finally, the merged firm may not reduce prices to all its customers. In particular, although the merged firm may have an incentive to reduce the price of a bundle of its complementary products post-merger, it may not have the incentive to reduce their prices when sold individually and may even have the incentive to increase them.

## *'One-stop shopping'*

- 4.220 An additional demand-side efficiency may arise when the merger firms' products are not substitutes and customers may have a stronger incentive to buy a range of products from a single supplier. This could be, for example, because purchasing from a single supplier reduces customers' transaction costs or, where products are complementary, benefits customers by ensuring improved product compatibility or quality assurance. This efficiency, which is an economy of scope in the purchase of goods rather than in their production, is sometimes called 'one-stop shopping'.

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<sup>103</sup>These efficiencies are known as Cournot effects.

## Part 5: Public interest cases

5.1 Merger control provides that the Secretary of State for BERR may intervene in a merger if he/she believes that a public interest consideration that has been, or will be, specified in the legislation may be relevant to a consideration of a merger. Where such an intervention is made, the Secretary of State assumes the role of decision-maker, and decisions are taken on the effects of the merger on the specified public interest consideration as well as on the basis of any consideration of the effects of the merger on competition. The legislation specifies that, in making decisions in public interest cases, the Secretary of State must accept the decisions the OFT and the CC make as to jurisdiction and whether the merger has led or may be expected to lead to an anti-competitive outcome. This Part of the guidelines describes how such cases are assessed and determined; separate sections deal with special public interest cases and cases falling under the ECMR.

### Public interest considerations

5.2 The public interest considerations, as currently specified in the Act as providing a basis for intervening in a merger, are:<sup>104</sup>

- (a) the interests of national security (including public security);
- (b) various considerations relating to the media (see further paragraphs 5.20 to 5.24); and
- (c) the interest of maintaining the stability of the UK financial system.<sup>105</sup>

5.3 The Act permits the Secretary of State to modify this list of public interest considerations to specify a new consideration or to remove or amend an existing consideration.<sup>106</sup>

### ***Powers of Secretary of State in respect of the OFT and the CC***

5.4 Once an intervention notice has been served, the OFT must prepare a report for the Secretary of State within such time period as the Secretary of State may require. The OFT's report must include decisions as to whether the OFT believes that it is, or may be, the case that:<sup>107</sup>

- (a) the Act's jurisdictional thresholds are satisfied;
- (b) the OFT's duty to refer a merger to the CC would otherwise be satisfied;
- (c) the market(s) concerned is of insufficient importance to justify a reference;

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<sup>104</sup>Section 58. See also the OFT's *Mergers—jurisdictional and procedural guidance*, Chapter 9.

<sup>105</sup>Added to the Act by Order 2008 No 2645: The Enterprise Act 2002 (Specification of Additional Section 58 Consideration) Order 2008; for text, see [www.opsi.gov.uk/si/si2008/uksi\\_20082645\\_en\\_1](http://www.opsi.gov.uk/si/si2008/uksi_20082645_en_1). The Secretary of State issued an intervention notice specifying this consideration in the context of the proposed merger between Lloyds TSB Group plc and HBOS plc. On 31 October 2008, the Secretary of State exercised his discretion not to refer the merger to the CC on the basis that the merger would result in significant benefits to the public interest as it relates to ensuring the stability of the UK financial system and that these benefits outweighed the potential for the merger to result in anti-competitive outcomes identified by the OFT. See [www.berr.gov.uk/files/file48745.pdf](http://www.berr.gov.uk/files/file48745.pdf).

<sup>106</sup>Save where the Secretary of State subsequently decides that there is no relevant public interest consideration, in which case the decision on whether or not to refer the merger to the CC reverts to the OFT under section 56.

<sup>107</sup>Section 44.

- (d) there are relevant customer benefits; and
- (e) undertakings in lieu of a reference are appropriate.
- 5.5 The OFT is not required to give any advice or make any recommendation on the relevant public interest consideration in its report (although it may do so) but will summarize, as required, any representations it receives relating to that consideration.
- 5.6 As indicated in paragraph 5.1, the Secretary of State is required to accept the OFT's findings on jurisdictional and competition matters. Anti-competitive outcomes must be treated as being against the public interest. However, in reaching a decision on whether the merger operates, or may be expected to operate, against the public interest, the Secretary of State may conclude that such an anti-competitive outcome is nevertheless justified by a relevant public interest consideration.<sup>108</sup>
- 5.7 Once the Secretary of State has received a report from the OFT (and Ofcom in the case of an intervention made in respect of a media merger—see further paragraph 5.23), he/she must decide whether to make a reference to the CC. The Secretary of State may make such a reference if he/she believes that:
- (a) It is or may be the case that a relevant merger situation has been created or will be created in the future.
- (b) Either:
- the merger has resulted or may be expected to result in an SLC and there is a relevant public interest consideration;<sup>109</sup> or
  - the merger has not resulted and may be expected not to result in an SLC but there is a relevant public interest consideration.
- (c) In either of the above cases, the Secretary of State believes that it is or may be the case that the merger operates or may be expected to operate against the public interest.
- 5.8 The Secretary of State may accept undertakings in lieu of a reference.<sup>110</sup>
- 5.9 If the Secretary of State decides that there is no relevant public interest consideration, the decision as to whether or not to refer the merger to the CC reverts to the OFT.<sup>111</sup>

### ***References on competition grounds***

- 5.10 As explained in paragraph 5.1, the Secretary of State may make a reference to the CC if he/she believes that it is or may be the case that: (a) a relevant merger situation has been created or will be created in the future; and (b) the merger has resulted or may be expected to result in an SLC and that there is a relevant public interest consideration.<sup>112</sup>

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<sup>108</sup>Sections 46(2) and 45(6).

<sup>109</sup>Sections 45(2) and 45(4).

<sup>110</sup>Schedule 7, paragraph 3.

<sup>111</sup>Section 56(1); see also footnote to paragraph 5.6.

<sup>112</sup>In cases where a reference is made on public interest grounds only, the CC will be asked to consider whether, taking account only of the admissible public interest consideration or considerations concerned, the creation of the relevant merger situation operates or may be expected to operate against the public interest (section 47(3) and (6)).

- 5.11 The following paragraphs explain the relevance of this guidance to those public interest cases referred to the CC when the CC must apply the SLC test.
- 5.12 The CC will decide<sup>113</sup> whether a relevant merger situation has been created, or whether arrangements are in progress or in contemplation which, if carried into effect, will result in the creation of a relevant merger situation and:
- (a) whether the creation of that situation has resulted, or may be expected to result, in an SLC; and
  - (b) whether, taking account only of any SLC and the admissible public interest consideration or considerations concerned, the creation of that situation operates or may be expected to operate against the public interest.
- 5.13 In these references, the CC will have regard to the various factors explained in Part 4 of this guidance in applying the SLC test in addition to taking into account the relevant public interest consideration in respect of which the case was referred.
- 5.14 When reporting on both the SLC question and a relevant public interest question, the CC will deal with each question separately. The CC will then consider whether, overall, the merger may be expected to operate against the public interest. A finding by the CC that there is an SLC shall be treated as being adverse to the public interest unless it is justified by one or more relevant public interest considerations.<sup>114</sup> The Secretary of State must accept the CC's views on whether there is a relevant merger situation and whether that merger results in an SLC.<sup>115</sup> The Secretary of State has discretion in relation to the public interest consideration and any remedies which are necessary to address any of the effects adverse to the public interest which have resulted from, or may be expected to result from, the creation of the relevant merger situation concerned.

### ***Remedies questions***

- 5.15 Subject to its decisions on the matters mentioned in paragraph 5.12, the CC may also be required to decide several questions concerning the taking of remedial action.
- 5.16 If the CC has decided that the relevant merger situation operates or may be expected to operate against the public interest, having regard to both the competitive aspects of the merger and the admissible public interest consideration(s), it must decide the following questions:<sup>116</sup>
- (a) whether action should be taken by the Secretary of State under section 55 for the purpose of remedying, mitigating or preventing any of the effects adverse to the public interest which have resulted from, or may be expected to result from, the creation of the relevant merger situation;
  - (b) whether the CC should recommend the taking of other action by the Secretary of State or action by persons other than itself and the Secretary of State for the purpose of remedying, mitigating or preventing any of the effects adverse to the public interest which have resulted from, or may be expected to result from, the creation of the relevant merger situation; and

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<sup>113</sup>See section 47.

<sup>114</sup>Section 45(6).

<sup>115</sup>Section 54(7).

<sup>116</sup>Section 47(7).

- (c) in either case, if action should be taken, what action should be taken and what is to be remedied, mitigated or prevented.
- 5.17 If the CC has decided that there is or is expected to be an SLC within any market or markets in the UK for goods or services, it must also answer separately the following questions:<sup>117</sup>
- (a) whether action should be taken by the CC for the purpose of remedying, mitigating or preventing the SLC concerned or any adverse effect which has resulted from, or may be expected to result from, the SLC;
- (b) whether the CC should recommend the taking of action by other persons for the purpose of remedying, mitigating or preventing the SLC concerned or any adverse effect which has resulted from, or may be expected to result from, the SLC; and
- (c) in either case, if action should be taken, what action should be taken and what is to be remedied, mitigated or prevented.
- 5.18 These questions are to be answered assuming that the CC will be required to take action. The CC will be required to take action if the Secretary of State, upon receipt of the CC's report, decides not to make a finding.<sup>118</sup>
- 5.19 In deciding the questions mentioned in paragraphs 5.16 and 5.17, the CC must have, in particular, regard to the need to achieve as comprehensive a solution as is reasonable and practicable to the adverse effects to the public interest; or, if appropriate, to the SLC and any adverse effects resulting from it.<sup>119</sup> If it has decided that there is or will be an SLC, the CC may also have regard to the effect of any action on any relevant customer benefits.<sup>120</sup>

### **Media mergers**

- 5.20 The public interest considerations relating to media mergers (newspapers and broadcasting) came into force in December 2003 when they were inserted into the Enterprise Act by the Communications Act 2003.<sup>121</sup>
- 5.21 Mergers raising media public interest considerations may be categorized as either relevant merger situations or special merger situations. If a media merger is categorized as a special merger situation, the CC will not apply the SLC test but will decide whether a special merger situation has been or will be created and decide whether, taking account only of the consideration or considerations mentioned in the reference, the creation of that situation operates or may be expected to operate against the public interest.<sup>122</sup> If a media merger is a relevant merger situation, the CC may apply both the SLC test and the public interest test or the public interest test alone, depending on the terms of the reference.

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<sup>117</sup>Section 47(8).

<sup>118</sup>Section 56(6).

<sup>119</sup>Section 47(9).

<sup>120</sup>Section 47(10). For the meaning of 'relevant customer benefits', see paragraph 6.12 and the CC's [Merger Remedies: Competition Commission Guidelines, CC8](#), November 2008, paragraphs 1.14–1.20.

<sup>121</sup>The amendments to the Enterprise Act were made by section 375(1) of the Communications Act and came into force on 29 December 2003 by virtue of Article 3(1), Schedule 1, of the Office of Communications Act 2003 (Commencement No 2) Order 2003 (S1 2003/3142).

<sup>122</sup>Section 63(3).

- 5.22 The Act specifies several public interest considerations that may be relevant in relation to media mergers. These are the need for:
- (a) accurate presentation of news and free expression of opinion in newspapers;<sup>123</sup>
  - (b) a sufficient plurality of views in newspapers in each market for newspapers in the UK or a part of the UK to the extent that it is reasonable and practicable;<sup>124</sup>
  - (c) there to be a sufficient plurality of persons with control of the media enterprises serving every different audience in the UK, or in a particular area or locality of the UK (the 'plurality test');<sup>125</sup>
  - (d) the availability throughout the UK of a wide range of broadcasting which (taken as a whole) is both of high quality and calculated to appeal to a wide variety of tastes and interests;<sup>126</sup> and
  - (e) persons carrying on media enterprises, and for those with control of such enterprises, to have a genuine commitment to the attainment in relation to broadcasting of the standards and objectives set out in section 319 of the Communications Act 2003.<sup>127</sup>
- 5.23 If the Secretary of State issues an intervention notice specifying one of the media public interest considerations, Ofcom must give a report to the Secretary of State containing advice and recommendations on the relevance of that consideration to the merger.<sup>128</sup> This report from Ofcom is in addition to the OFT's report referred to in paragraph 5.4. Detailed guidance on how the media merger public interest provisions are operated is available on the BERR website.<sup>129</sup>

### ***Special public interest cases***

- 5.24 The Act provides for an exceptional category of mergers which can be referred on public interest consideration grounds only when the normal jurisdictional thresholds relating to turnover or share of supply in the Act are not satisfied. These are certain media mergers (see paragraph 5.21) and mergers involving a government contractor (past or present) who holds confidential material related to defence—so triggering the consideration of national security. This type of merger is a special merger situation.
- 5.25 A media merger is categorized as a special merger situation if:<sup>130</sup>

*either*

- (a) in relation to the supply of newspapers of any description, at least one-quarter of all the newspapers of that description which were supplied in the UK, or in a substantial part of it, were supplied by the person or persons by whom one of the enterprises concerned was carried on;

*or*

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<sup>123</sup>Section 58(2A).

<sup>124</sup>Section 58 (2B).

<sup>125</sup>Section 58(2C)(a). The CC approach to analysis of the 'plurality test' is currently—April 2009—subject to an appeal.

<sup>126</sup>Section 58(2C)(b).

<sup>127</sup>Section 58(2C)(c).

<sup>128</sup>Section 44A.

<sup>129</sup>[www.berr.gov.uk/files/file14331.pdf](http://www.berr.gov.uk/files/file14331.pdf).

<sup>130</sup>Section 59(3C) and (3D) respectively.

(b) in relation to the provision of broadcasting of any description, at least one-quarter of all broadcasting of that description provided in the UK, or in a substantial part of it, was provided by the person or persons by whom one of the enterprises concerned was carried on.

5.26 Similar procedures to those in public interest cases apply.<sup>131</sup> The Secretary of State must issue a special intervention notice; the OFT makes a report as to whether it is or may be the case that a special merger situation has been or will be created, including any other relevant advice, recommendations on the public interest consideration and a summary of any representations about the case.<sup>132</sup> Where the special intervention notice specifies a media public interest consideration, Ofcom is required to produce a report on the effect of that media public interest consideration on the case. The Secretary of State may refer the case to the CC if he/she believes that it is or may be the case that: a special merger situation has been created or is in progress or contemplated; that a public interest consideration is relevant; and that, taking account of that consideration, the merger operates or may be expected to operate against the public interest.<sup>133</sup> Where a special merger situation is referred to the CC, the CC cannot consider the question of whether the merger will result in an SLC.

5.27 The CC considers these points and, if it considers that the merger operates or may be expected to operate against the public interest, makes recommendations as to the action the Secretary of State or others should take to remedy any adverse effects.<sup>134</sup> It reports on those matters to the Secretary of State. The Secretary of State makes the final decision on the public interest test and takes whatever remedial steps he considers necessary.<sup>135</sup>

### ***Mergers with a Community dimension***

5.28 In cases where a merger falls to be examined under the ECMR (see paragraphs 1.12 to 1.14), the Act makes provision for the referral of the merger to the CC when the Secretary of State believes that one or more public interest considerations is concerned.<sup>136</sup> These mergers are essentially treated as a special category of special merger situations (see paragraphs 5.25 to 5.28).

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<sup>131</sup>Section 59.

<sup>132</sup>Sections 60 and 61.

<sup>133</sup>Section 62.

<sup>134</sup>Section 63.

<sup>135</sup>Section 66.

<sup>136</sup>Sections 67 and 68.

## Part 6: Interim measures and remedies

6.1 The Act provides that a merger, whether completed or in prospect, that has resulted in or is expected to result in an SLC can be prohibited or have conditions imposed on its continued operation. This Part of the guidelines describes the OFT's powers to seek and accept undertakings in lieu of a reference and the initial steps the OFT and the CC can take to forestall actions by the merger parties that might subsequently make it more difficult for the CC to impose any remedies, and the remedy powers of the CC.

### OFT initial undertakings and initial enforcement Orders

6.2 Under the Act, the OFT may accept initial undertakings from parties where it is considering whether to make a reference in relation to a completed merger.<sup>137</sup> This power allows the OFT to act to prevent pre-emptive action by the merger parties before it has reached a definite conclusion on whether to refer the merger to the CC. The OFT may ask the parties to give undertakings not to carry out any action that might prejudice the merger reference or the ability of the CC to act following the outcome of its inquiry. These undertakings are legally binding.

6.3 The Act also permits the OFT to make an Order where it is considering whether to make a merger reference.<sup>138</sup> The OFT may only make initial Orders in respect of completed mergers where it has reasonable grounds for suspecting that it is or may be the case that action is in progress or in contemplation that might prejudice the merger reference or the ability of the CC to act following the outcome of its inquiry.

6.4 For full details on the OFT's initial undertakings and Orders, see OFT [Mergers—Jurisdictional and procedural guidance](#).

### Undertakings in lieu of reference

6.5 The Act allows the OFT to seek and accept undertakings from one or more parties to a merger in lieu of a reference.<sup>139</sup>

6.6 The OFT may make an Order when an undertaking in lieu of reference has not been complied with.<sup>140</sup> In such circumstances, the OFT could seek to enforce the original undertaking in the courts<sup>141</sup> or decide to replace it with an Order.

6.7 For full details on undertakings in lieu of reference, see OFT [Mergers—Jurisdictional and procedural guidance](#).

### CC interim undertakings and Orders

6.8 When a merger is referred to the CC, it will consider whether interim undertakings or an interim Order are necessary to prevent 'pre-emptive action' by the merger parties which might prejudice the outcome of the reference or impede the CC from later taking remedial action if the CC were to conclude that there was an SLC.<sup>142</sup> For

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<sup>137</sup>Section 71.

<sup>138</sup>Section 72.

<sup>139</sup>Section 73.

<sup>140</sup>Section 74.

<sup>141</sup>Section 75.

<sup>142</sup>Sections 80 and 81.

example, integration of activities by the merger parties could reduce the possibility of successful divestiture. Such interim measures seek to preserve the CC's scope for action if it were to reach an adverse finding.<sup>143</sup> The CC can also, for the same purpose, adopt any initial undertakings or Order implemented by the OFT in relation to a completed merger within seven days of the reference being made.

- 6.9 Details on interim measures are given in [Appendix A](#) of CC guidance *Merger Remedies: Competition Commission Guidelines, CC8*.

### The CC: selection of remedies

- 6.10 Where the CC concludes that there is an anti-competitive outcome, it is required to decide whether action should be taken to remedy, mitigate or prevent the SLC or any adverse effect resulting from the SLC.<sup>144</sup> The CC is also required to decide whether such action should be taken by itself or recommended for others, such as the Government, regulators or public authorities. These decisions are set out in the CC's report and implementation generally follows publication of the report.
- 6.11 When considering whether to take action, the CC is required to have particular regard to the need to achieve as comprehensive a solution as is reasonable and practicable to the SLC and any adverse effects arising from it.<sup>145</sup> In this connection, the CC seeks remedies that are effective in addressing the SLC and its resulting adverse effects. It will then select the most proportionate but least costly and intrusive of the remedy options.
- 6.12 It may have regard, in accordance with the Act, to any relevant customer benefits arising from the merger. Relevant customer benefits are limited by the Act to lower prices, higher quality or greater choice or greater product or service innovation. The CC will normally take relevant customer benefits into account only after it has decided on the existence of an SLC by considering the extent to which alternative remedies may preserve such benefits.
- 6.13 Detailed information about the CC's consideration of remedial actions, including effectiveness, cost and proportionality and relevant customer benefits, is given in CC guidance, *Merger Remedies: Competition Commission Guidelines, CC8* (for customer benefits, in particular, see paragraphs 1.14 to 1.20).

### CC final undertakings and orders

- 6.14 If the CC decides to implement, it will normally seek to do so by obtaining undertakings from the relevant merger firms or merged firm. However, the CC also has the option of implementing remedies by making an Order, subject to the limitations set out in Schedule 8 to the Act.

### Failure to comply

- 6.15 If a person fails to comply with any undertakings that it has given or any Order imposed on it by the CC, compliance may be enforced by means of civil proceedings brought by the OFT or the CC. Any person affected by the contravention of under-

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<sup>143</sup>In *Stericycle v Competition Commission Case (1070/4/8/06)*, the CAT stated that the CC has considerable margin of appreciation in making interim orders, having regard to the need to safeguard the effectiveness of any divestiture that may ultimately be ordered.

<sup>144</sup>The questions are summarized in paragraph 2.12.

<sup>145</sup>Sections 34(4) and 36(3).

takings or an Order may also bring an action for any loss or damage sustained as a result of such contravention.

## Part 7: Publications relevant to the UK merger regime

### Competition Commission publications

[www.competition-commission.org.uk](http://www.competition-commission.org.uk)

CC7 Chairman's Guidance on Disclosure of Information in Merger and Market Inquiries

CC8 Merger Remedies: Competition Commission Guidelines

Competition Commission Annual review and accounts

Suggested best practice for submissions of technical economic analysis from parties to the Competition Commission

([www.competition-commission.org.uk/rep\\_pub/corporate\\_documents/corporate\\_policies/best\\_practice.pdf](http://www.competition-commission.org.uk/rep_pub/corporate_documents/corporate_policies/best_practice.pdf); and [www.competition-commission.org.uk/press\\_rel/2009/feb/pdf/07-09.pdf](http://www.competition-commission.org.uk/press_rel/2009/feb/pdf/07-09.pdf)).

### OFT publications

[www.oft.gov.uk](http://www.oft.gov.uk)

OFT 508 Overview of the Enterprise Act

OFT [pending] Mergers—jurisdictional and procedural guidance

*Forthcoming*: OFT Mergers: undertakings in lieu and markets of minor importance

### Competition Appeal Tribunal publications

[www.catribunal.org.uk](http://www.catribunal.org.uk)

Competition Appeal Tribunal Rules

### Department for Business, Enterprise and Regulatory Reform

See [www.berr.gov.uk/whatwedo/businesslaw/competition/mergers/public-interest/index.html](http://www.berr.gov.uk/whatwedo/businesslaw/competition/mergers/public-interest/index.html).