

COMPETITION COMMISSION/OFFICE OF FAIR TRADING

JOINT MERGER ASSESSMENT GUIDELINES SEMINAR

held at

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London WC1B 4AD

on

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Cliffords Inn, Fetter Lane, London EC4A 1LD  
Tel 0207 269 0370

## PANELLISTS

### **Chairman**

Mr Peter Freeman (Chairman, CC)

### **Panel**

Ms Amelia Fletcher (Chief Economist and Senior Director of Mergers, OFT)

Mr Chris Bowden (Legal Adviser, CC)

Mr Robin Finer (Director of Economic Analysis, CC)

Ms Morven Hadden (Legal Director, CC)

Mr Nicola Mazzarotto (Head of Policy Analysis, CC)

Mr Nicholas Scola (Assistant Director - Legal, OFT)

Mr Chris Walters (Assistant Director of Mergers, OFT)

1 INTRODUCTION

2  
3 CHAIRMAN: Ladies and gentleman—and Lord Blackwell if he is  
4 here—good afternoon and welcome to the Competition  
5 Commission on the occasion of this joint OFT/CC  
6 consultation meeting. This is part of our consultation on  
7 the airing of the draft merger assessment guidelines.

8 One thing I have not been able to do in this place is  
9 make all the clocks tell the same time. I believe it is  
10 2.10 by *that* clock, not by *those* two, but do not worry.  
11 People wonder why we cannot make all the clocks work.

12 I am sorry if some of you received misallocated  
13 badges; that is to say, you were given the right names but  
14 some were allocated to institutions that they had either  
15 left or had no intention ever of joining. It does not  
16 apply to all of you, but it is a case where you cannot  
17 even rely on the unreliability of the labels. That is out  
18 of our hands. We live in a rented building and the  
19 security is managed by others.

20 Why are we doing this exercise? We are doing it  
21 really for three reasons: first, to take account of and  
22 try to share the lessons that both the OFT and CC have  
23 learnt from five or six years of application of the  
24 previous guidelines under the Enterprise Act in different

1 ways; second, simply to contribute to transparency and  
2 understanding; and, third, I suppose it is to help reduce  
3 the burden on business. That is the great cry these days.

4 To deal with those matters in reverse order, as to  
5 lifting the burden and increasing transparency we receive  
6 criticisms, not many, of the merger regime in this  
7 country, not so much that it delivers the wrong decisions  
8 but that it is heavy, intrusive and time-consuming. The  
9 draft guidelines give us the opportunity to implement some  
10 process improvements and make the analysis clearer so we  
11 can improve that. Our job jointly is to make the UK system  
12 work efficiently and effectively. All competition  
13 authorities face the task of getting right the balance  
14 between phase one and phase two. We have already made some  
15 progress there. The wider availability of undertakings in  
16 lieu and greater use by the OFT of *de minimis* have already  
17 brought about some improvements and there may be further  
18 scope for the introduction of more fast tracking of  
19 mergers that clearly should go to phase two, not hanging  
20 around at phase one unnecessarily. I hope that these  
21 guidelines will help to bring that about. The objective is  
22 to make sure the work is correctly allocated so that the  
23 right cases are dealt with with the right emphasis by the  
24 right authority in the right way. We can debate all

1 afternoon whether we could have a better system, but that  
2 is not the purpose of this consultation which is to  
3 contribute towards making the present system work  
4 effectively.

5 In terms of lessons learnt, what you read in the  
6 draft document shows how our assessment has evolved. We  
7 are not talking here about radical change but about  
8 evolution and taking account of it so that what we publish  
9 and rely on is genuinely up to date. I shall not say any  
10 more about how we have evolved; others will talk about  
11 that this afternoon, but the function of it is to take  
12 account of that evolution.

13 I suppose that another area where the guidelines may  
14 be helpful is the definition of a merger. It may be  
15 absolutely obvious but it is necessary to be clear about  
16 to what situations the system is being applied. We thought  
17 we had got it clear but there is some litigation still  
18 under way as to what material influence may comprise in a  
19 particular case. I would like to feel we were all agreed  
20 at least on the principles we are applying and that the  
21 disputes that are going on are about how they are applied.  
22 In that respect the consultation document you have is  
23 necessarily incomplete because we do not second guess what  
24 the Court of Appeal may say.

1           The other area where there is some interesting  
2 material in the document is public interest. When we were  
3 writing commentaries on the Enterprise Act nobody paid  
4 much attention to the public interest; it was always the  
5 bit at the back. People said that there were also the  
6 public interest arrangements. For a number of reasons the  
7 public interest aspects of merger control have come to the  
8 fore recently not only as a result of hard times in the  
9 banking world but also in the area of media mergers where  
10 they are obviously very significant and the interplay  
11 between the authorities and the secretary of state and the  
12 criteria applied are obviously very important. Again,  
13 there is litigation going on so we do not have the last  
14 word on that.

15           There is also the issue of financial stability. We  
16 have had a demonstration that the list of public interest  
17 criteria is not closed and can be amended even during the  
18 passage of a particular case. That was never in doubt but  
19 it is interesting to see how it works. We shall not waste  
20 too much time wringing our hands over Lloyds and HBOS, if  
21 anybody is so inclined. As I have said several times, I  
22 regard that as an example of the system working as opposed  
23 to not working.

1           We have a galaxy of talent here and my job is to hold  
2 the ring. I want to finish on time, which is 4.30 by the  
3 clock over *there*. We shall try to provide as much  
4 opportunity for discussion as possible while also trying  
5 to structure the presentations around the various topics  
6 that have been identified. A record is being made. The  
7 stenographer *there* is by far the most important person in  
8 the room and if you cannot make your mark with her you may  
9 as well not be here. Therefore, when we get to the  
10 discussion—there will be a roving microphone—please  
11 identify yourselves. That is very important for the  
12 written record. We will try to do the same.

13           I am sure that I should be reading fire instructions.  
14 Basically, if the fire alarm goes off proceed slowly in  
15 *that* direction and gather in Bloomsbury Square.

16           This seminar is part of a wider consultation  
17 exercise; it is open government. We are delighted to have  
18 you here. I think the next person to take us forward is  
19 Amelia Fletcher.

20  
21 **OVERVIEW OF CHANGES IN SLC METHODOLOGY**

22  
23 MS FLETCHER: If Peter is the compère for today's entertainment  
24 then I am the warm-up act for the talent that comes later.

1 I shall be very brief by giving an introductory overview  
2 of some of the main changes that we think we have made in  
3 the guidelines to the SLC methodology employed when  
4 carrying out merger assessment, but there are plenty of  
5 other little nuances and changes that will emerge in the  
6 ensuing talks.

7 Essentially, I want to highlight four main areas of  
8 change since 2003 where we think development has occurred  
9 in the light of experience of cases, both our own and  
10 those more widely particularly in Europe, and also as a  
11 result of growing economic understanding of the things we  
12 are looking at and how we can apply the economics to the  
13 policy.

14 The four main areas I want to highlight where there  
15 have been developments are: market definition; co-  
16 ordinated effects, where we had a really useful academic  
17 round table (in which some of those here were involved) to  
18 think about the economics in that area and likewise we  
19 also had a round table on the third area, non-horizontal  
20 mergers; and, lastly, efficiencies. I shall discuss each  
21 in turn briefly, but much more detail will be provided  
22 later.

23 As to market definition I think the main thing we  
24 seek to do in the guidelines is downplay its role. It

1 remains very important but not as important as is  
2 sometimes made out. We are trying to downplay the role of  
3 market shares and concentration as well. In turn, in the  
4 area of unilateral effects we seek to raise the profile of  
5 the actual analysis of the competitive constraints that  
6 the merging parties place upon each other, which would be  
7 lost as a result of the merger.

8 What is not on this slide, though I suspect it will  
9 result in later discussion, is what we have said in the  
10 guidelines about the probative nature, when looking at the  
11 unilateral effects, of the combination of high diversion  
12 ratios and profit margins. This is another change in the  
13 guidelines.

14 Another change that may result in discussion is the  
15 emphasis we have placed on changing the role of supply  
16 side substitution. We have also emphasised some of the  
17 complications in market definition, for example around  
18 multi-sided markets.

19 As to co-ordinated effects we have broadly followed  
20 what is becoming established practice in using three  
21 conditions: first, that the parties can reach and monitor  
22 co-ordination. We can think of that as the 'ability'  
23 condition. The second one is that there is internal  
24 stability of the co-ordination. You can think of that as

1 the incentive condition. Do the parties have the incentive  
2 to maintain this co-ordination? The third condition is the  
3 external stability condition. Whatever the parties do, can  
4 they make this co-ordination work? Can it have an effect?  
5 Therefore, that is the 'effect' condition. It is quite  
6 interesting that you can look at these three conditions as  
7 ability, incentive and effect in the same way we are now  
8 seeking to do in the non-horizontal part of the guidelines  
9 to which I will come in due course.

10 There are two cross-cutting factors we have  
11 highlighted as affecting all three of these elements. The  
12 first is evidence of pre-existing co-ordination. There are  
13 some interesting questions to be asked around that point.  
14 What kind of evidence of pre-existing co-ordination do we  
15 need and in what circumstances might we actually draw on  
16 that? The second factor is the role of concentration and  
17 symmetry both of which potentially affect all three of  
18 those steps. We think that our approach, which is  
19 essentially that there must be a story of why the merger  
20 would enhance the likelihood of co-ordination, is broadly  
21 consistent with recent EC co-ordinated effects cases post-  
22 Impala such as ABF/GBI (Yeast).

23 As to non-horizontal mergers, we very clearly  
24 recognise in the guidelines that most of these will be

1 benign at worst and probably beneficial because there is  
2 not a reduction in competition between competitors and  
3 because efficiencies can be garnered from the combination  
4 of a supplier and downstream firm. As we discovered  
5 earlier, the badges might well have come out right had the  
6 CC done it themselves rather than delegated it downstream.  
7 Maybe a vertical merger would have been good!

8           However, what we do talk about in the guidelines is  
9 diagonal mergers which arise where a supplier, rather than  
10 merging with its own distributor, merges with its  
11 competitors' distributor or another player's distributor.  
12 In that circumstance the anti-competitive effects tend to  
13 be greater, the efficiency benefits would tend to be  
14 smaller, and one might think it would be more likely to  
15 raise the sorts of concerns that one sees in horizontal  
16 mergers. In reality, there is likely to be a spectrum of  
17 vertical mergers, with many having elements of the pure  
18 vertical, which tend to be benign, and of the diagonal,  
19 which tend to be more problematic. Obviously mergers along  
20 this spectrum are particularly difficult to analyse. In  
21 analysing them we broadly follow DG Comp's guidance which  
22 is obviously a lot longer and more detailed than ours. The  
23 overarching framework is to look at the ability, incentive

1 and likely effect of the merging parties to engage in  
2 either full or partial foreclosure.

3 I am a great fan of Venn diagrams and this one  
4 attempts to illustrate the interrelated nature of each of  
5 these elements. 'Ability' is primarily about market power;  
6 'incentive' is around whether the foreclosure, full or  
7 partial, will be profit-enhancing; and the main point to  
8 highlight on 'effect' is that we are not necessarily  
9 concerned about the impact on competitors but on  
10 competition. That is where 'efficiencies' comes into play  
11 because sometimes efficiencies resulting from the merger  
12 mean that competition may be stronger even though some  
13 competitors are potentially harmed.

14 One other thing that may generate discussion is that  
15 we have made an explicit distinction between the OFT and  
16 the CC treatment of non-horizontal mergers. We have said  
17 that if the OFT finds there is a realistic likelihood of  
18 incentive and ability then we do not need to go on to look  
19 at effect; we can just presume effect, unless there are  
20 very good arguments to the contrary. The CC will do a full  
21 incentive-ability-effect analysis.

22 Finally, on efficiencies obviously we shall keep the  
23 two gateways that legislation gives us but what we have  
24 endeavoured to do in the guidelines is try to clarify the

1 distinction between those efficiencies that prevent an SLC  
2 from occurring at all and those customer benefits which  
3 can countervail the negative effects of an SLC, which  
4 means that even though there is an SLC we think the merger  
5 should be allowed to proceed.

6 We have also dropped the terminology of rivalry-  
7 enhancing efficiencies. We felt that the term 'rivalry-  
8 enhancing' came to mean one particular situation, namely  
9 where two small players merge and thereby can compete more  
10 effectively against one bigger competitor. We thought that  
11 whilst that was a perfectly good story it was only a  
12 subset of the potential efficiency arguments that we might  
13 want to accept in a merger. It is possible that the term  
14 'rivalry-enhancing' drawn more widely could cover  
15 everything we wanted it to but we thought it was easier  
16 just to drop the term.

17 We have gone through a number of different  
18 efficiencies that we would be interested in looking at. We  
19 have also categorised them into demand side and supply  
20 side efficiencies. I think this is useful but it may also  
21 generate discussion.

22 That is all from me. The first main act on today is  
23 nothing to do with any of the things I have mentioned. For  
24 some in the room it is probably more interesting than any

1 of the more 'economic' stuff. I notice that today the  
2 lawyers and economists have been separated. This does not  
3 at all reflect the way in which we have worked on these  
4 guidelines. It has been an incredibly tightly-knit effort  
5 by lawyers and economists and others across the OFT and  
6 the CC, so I hope that will prove itself today.

7 CHAIRMAN: We thought that distinction was better than having  
8 OFT on one side and the CC on the other. We do not propose  
9 to take questions now; that is a genuine warm-up act.  
10 Therefore, we shall move straight on to the next topic  
11 which is a double act that will generate discussion.

12  
13 **THE COUNTERFACTUAL**

14  
15 MS HADDEN: As lawyers, both Nick and I perhaps feel we are  
16 slight frauds sitting here discussing a concept that does  
17 not appear anywhere in the legislation. However, the  
18 counterfactual is an important part of the framework for  
19 assessing whether a merger gives rise to an SLC. The  
20 concept is one that I am sure is known to everyone in the  
21 room. Establishing whether or not a merger gives rise to  
22 an SLC involves a comparison of the prospects for  
23 competition with the merger against the competitive  
24 situation without it, the latter being the counterfactual.

1           Generally, both the OFT and CC will assess the  
2 counterfactual over the foreseeable future in the same way  
3 that the effects of the merger are analysed. That is not  
4 always straightforward. There may be cases where the  
5 foreseeable future turns out to be quite a short period in  
6 practice. However, one important matter to bear in mind is  
7 that the developments that would have arisen, or might be  
8 expected to arise, as a result of the merger do not form  
9 part of the counterfactual; that is part of the  
10 competitive assessment. It is not always easy to determine  
11 on which side of the line developments will fall; in  
12 particular, if there are market developments that may be  
13 accelerated in some way as a result of the merger.

14           We shall conduct a brief canter through it and if  
15 there are any questions we shall be very happy to defer  
16 them, probably to our economist colleagues! We will do our  
17 best to take you through the cases that we have been  
18 looking at in developing the guidelines. We want to look  
19 generally at the differences in approach as between the  
20 OFT and CC. There are acknowledged differences. That is  
21 entirely appropriate because we are different authorities  
22 with different statutory roles and obligations. We must  
23 answer different questions to a different standard and  
24 that is reflected in our treatment of some of these

1 issues. Within that we shall be looking at two primary  
2 areas: the failing firm and how we approach multiple bids  
3 and parallel transactions.

4 MR SCOLA: Just kicking off with the general approach to the  
5 counterfactual that the OFT adopts, obviously our  
6 reference test is that we have a duty to refer whenever  
7 there is a realistic prospect of an SLC and that must take  
8 account of the fact that there are a number of different  
9 possible counterfactuals against which the merger should  
10 be judged. As a first phase agency we do not have the time  
11 and luxury to delve into what that actually would be on a  
12 balance of probabilities assessment, but when we look at  
13 the merger we need to take account of the fact that there  
14 is a degree of uncertainty as to what would have happened  
15 absent that merger.

16 The way we attempt to reconcile this tension  
17 effectively is by adopting a working presumption that the  
18 prevailing conditions of competition at the time of the  
19 merger are those against which the merger should be  
20 judged. I think that would generally equate to what you  
21 might call a relatively cautious approach to merger  
22 assessment which is appropriate given the level of the  
23 statutory test. But that is very much a working  
24 presumption and clearly can be rebutted in the presence of

1 appropriate evidence. The type of evidence that is  
2 pertinent might be the exit of one of the two firms in  
3 question which is something we frequently encounter in  
4 argument and will come on to consider. Obviously, one  
5 piece of evidence from the parties is a failing firm-style  
6 defence and an exiting firm defence.

7 The other way in which the presumption of prevailing  
8 conditions of competition can be rebutted is if we  
9 ourselves have information to suggest that one of the two  
10 parties at the time of the merger would have gone on to do  
11 something more competitive in the market, for example  
12 would have entered a new market in which it was not  
13 engaged at the time of the merger. Typically, that is  
14 evaluated in the form of a potential competition story.

15 MS HADDEN: By contrast with the OFT generally the CC does not  
16 operate on the basis of presumptions. We are required to  
17 answer the statutory questions on the basis of an  
18 expectation—what we think is more likely than not to  
19 occur—or the civil standard of the balance of  
20 probabilities. That also accords with our approach in  
21 relation to the counterfactual. We will consider what is  
22 the most likely outcome in the market under investigation  
23 and look at the counterfactual on that basis. This often  
24 involves looking at the prevailing conditions of

1 competition but that is not always the case. We will  
2 consider whether changes in the market are likely absent  
3 the merger and how we should approach those. It is not  
4 always straightforward. Sometimes those changes in the  
5 market are things that would have happened even if the  
6 merger had not taken place but they are happening a little  
7 more quickly because it has taken place. That can  
8 complicate the counterfactual analysis, and it was an  
9 issue with which we had to grapple recently in the  
10 BOC/Ineos inquiry, but generally speaking the main  
11 difference in the approach of the two authorities is that  
12 we are required to satisfy ourselves on the basis of an  
13 expectation and for that reason we will not rely on  
14 rebuttal presumptions.

15 MR SCOLA: In terms of specifics I want to look at a failing  
16 firm or exiting firm argument in order to prevent an SLC  
17 which is covered in the guidance. I do not think there has  
18 been a seismic shift from the previous guidelines issued  
19 by the OFT and Competition Commission, but obviously this  
20 is an area of interest given current conditions, which is  
21 why we think it is worth touching on here.

22 Effectively, there are two limbs, sometimes three  
23 depending on how you split the various components. The  
24 first one, which is uncontroversial, is that one of the

1 businesses in question would inevitably have exited the  
2 market and there should be no serious prospect of  
3 reorganisation of that business internally. The guidelines  
4 say that generally this will not be the sale of a division  
5 by an otherwise successful and profitable firm, but in  
6 rare circumstances that criterion may still be met in such  
7 circumstances, for example where a firm has inevitably  
8 committed to disposing of a certain line of business and  
9 it is genuinely committed to exiting the market. One  
10 example of that scenario is the Homebase/Focus decision by  
11 the OFT.

12 To the extent that the firm in question can  
13 demonstrate that it would inevitably have exited the  
14 market absent the merger the next limb is effectively  
15 whether there is a substantially less anti-competitive  
16 alternative to an acquisition by the acquirer in question.  
17 This really splits into two different parts. First, was  
18 there a substantially more competitive buyer for the  
19 business as a going concern? Second, if that is not the  
20 case, is there a substantially less anti-competitive  
21 alternative to the merger in the form of the actual exit  
22 of the firm itself? That sounds slightly strange when you  
23 consider that failure of the firm might mean there is  
24 greater competition, but effectively it is looking at a

1 situation in which the firm has gone into liquidation and  
2 is disbanded, but perhaps its assets are used as a way to  
3 enable other firms to enter the market even though they  
4 are not purchasing the business. Alternatively, it may  
5 simply be the case that other firms would fill the market  
6 share void left by the exiting firm in question.

7 One interesting point that the guidelines flesh out  
8 is that, when considering realistic alternative buyers for  
9 the business, we take account only of buyers who are  
10 willing to pay above liquidation value. That is perhaps  
11 something on which we can touch later.

12 There are differences in approach here between the  
13 OFT and the CC reflecting the different substantive tests  
14 that we talked about earlier. The phrase fairly well used  
15 in OFT decisions is that it requires "compelling evidence"  
16 that these limbs are satisfied, not least because these  
17 types of arguments are very easy to allege and obviously  
18 in some senses can be a get-out-of-jail-free card if the  
19 parties are able to substantiate them properly. Therefore,  
20 we are very cautious in assessing the way in which we look  
21 at these 'exiting firm' cases.

22 As Morven has explained, the Competition Commission  
23 assesses the merger on the standard of likelihood.  
24 Therefore, to the extent it regards these limbs as being

1 satisfied, namely that the party in question would exit  
2 the market but there would have been an alternative  
3 purchaser, it is comparing effectively the two mergers one  
4 against the other; in other words, does this merger result  
5 in an SLC compared with the counterfactual which is a  
6 purchase by the other party? This is an interesting  
7 difference in the approach of the OFT and CC in looking at  
8 this question, which reflects the statutory tests.

9 MS HADDEN: There is one final point to make in relation to the  
10 'failing firm' criteria. Although we operate on the basis  
11 of an expectation nevertheless we push parties quite hard  
12 to establish that those criteria are met. We will look  
13 very carefully at the financing of the business and at  
14 what alternatives are out there, including whether a  
15 business will genuinely be pushed to the point of  
16 liquidation or whether the sell off through administration  
17 of either the business as a whole or in part is something  
18 we consider to be a more likely alternative. That was a  
19 matter which came up in the Thermo Electron  
20 Manufacturing/GV Instruments case.

21 The other area on which we want to touch this  
22 afternoon is competing bids and parallel transactions. In  
23 some senses parallel transactions are not necessarily  
24 issues relating to counterfactual although they are dealt

1 with within that section of our guidance largely as a  
2 matter of convenience. Looking through the guidance, these  
3 things should not really come as any great surprise to  
4 you. These are not new statements of policy but a  
5 reflection of our existing practice and the way it has  
6 developed over the time that we have been looking at cases  
7 under the Enterprise Act.

8         Considering first competing bids, the OFT approach is  
9 primarily to consider the merger as against prevailing  
10 conditions of competition which means that the OFT will  
11 examine each competing bid separately and whether the  
12 particular merger creates a realistic prospect of an SLC  
13 as against prevailing conditions of competition. The CC  
14 approach is one based on expectation of the most likely  
15 outcome, so if only one of the competing bids is referred  
16 to the Competition Commission the counterfactual is likely  
17 to be the pre-merger competition conditions which may  
18 include an assessment of how likely it is that the non-  
19 referred bid will proceed. In practice the analysis may  
20 not be all that different, but we shall be looking at  
21 either pre-merger competition conditions or an expectation  
22 that the alternative bid that has not come to us—so by  
23 definition it has not been found to give rise to  
24 competition concerns—would proceed.

1           The situation is slightly different where two or more  
2 bids are referred to the Competition Commission. In that  
3 case the counterfactual is unlikely to be any of the bids  
4 referred to us because a prima facie competition concern  
5 has been identified. Similarly, in general the CC will not  
6 consider a remedied bidder as a suitable counterfactual.  
7 There is an exception to that in a very distinct set of  
8 cases concerning railway franchises. This is set out in a  
9 little more detail in the guidance, but in those cases we  
10 cannot rely on the pre-merger situation because that will  
11 not continue to be the case. It is inevitable that the  
12 franchise will be awarded to one of the short-listed  
13 bidders. Therefore, in those cases we will consider the  
14 counterfactual as an award to a bidder that has not been  
15 referred to us, if any of them have not been referred, or,  
16 if all of the bidders raise competition concerns, we will  
17 treat the counterfactual as a hypothetical bidder with any  
18 competition concerns remedied most likely through  
19 behavioural measures.

20           Parallel transactions are a slightly different  
21 construct. In considering such transactions the OFT will  
22 usually consider whether there is a realistic prospect of  
23 competition whether or not the parallel transaction  
24 proceeds. By contrast, the CC looking at expectations will

1 consider whether or not it believes that that parallel  
2 transaction is likely to proceed and, if so, its  
3 counterfactual will take account of that.

4 That is a quick canter through counterfactual. We are  
5 happy to take questions, or refer them to colleagues here,  
6 in relation to the approach of either authority. There  
7 will be an opportunity to take questions later in the  
8 course of the proceedings.

9 MR GAVIN ROBERT (Linklaters): In relation to parallel  
10 transactions do you apply the same rule that the European  
11 Commission applies around first come first served? I was  
12 surprised that such discussion was not in the draft  
13 guidance.

14 MS HADDEN: That is primarily because we have not been put in a  
15 situation where we have had to put that to the test. It  
16 has been considered in the context of LSE by the OFT.

17 MR SCOLA: We have looked at it in that context and most  
18 recently we have looked at it in a steel manufacturing  
19 case (Celsa). Obviously, there would be a conceptual  
20 benefit in trying to align our practice with the European  
21 Commission to provide certainty and predictability. At  
22 least at the OFT stage, however, I do not believe that is  
23 something we are doing for the reason that the advice we  
24 have received is that when looking at the realistic

1 prospect test, we must take account of the possibility  
2 that we may be judging the merger against a number of  
3 different outcomes, one of which is whether or not some of  
4 the parallel transactions go ahead. For us simply to say  
5 that because a particular deal came to our notice first we  
6 are ignoring the other deal is to deem too much to have  
7 happened (or not to have happened). It also raises quite  
8 difficult questions in terms of the voluntary regime and  
9 the completed/anticipated dynamic which is not something  
10 that the European Commission has because of the way the  
11 system works. Therefore, I think the answer is no.  
12 Certainly, at the first phase we would not adopt a strict  
13 first-past-the-post approach.

14 MS HADDEN: In relation to the CC the key factor is its  
15 expectation of what is the likely outcome and the mere  
16 timing of the transaction does not necessarily mean that  
17 inevitably we would reach the expectation that that  
18 transaction would go ahead. Timing might be one of the  
19 issues but it is not necessarily the only thing that would  
20 be looked at in our analysis.

21 MR ROBERT: I just comment that given the radical impact of a  
22 first-past-the-post rule some discussion of it in the  
23 guidance—to say that you are not applying it or you might  
24 apply it—would be important for the purpose of legal

1       certainty. That is particularly important for the  
2       Competition Commission in terms of both parallel  
3       transactions. Because of the way Mr Scola suggested they  
4       might be looked at by the OFT both parallel transactions  
5       might be referred. It would then become of absolutely  
6       critical importance in an oligarchical market structure  
7       with parallel transactions.

8       CHAIRMAN: We will take that away and look at it. There are a  
9       number of ways in which procedurally our regime is not  
10      aligned with that of the EU. As you well know, it is not a  
11      compulsory notification system.

12     MR SIMON PRITCHARD (Allen & Overy LLP): Nick, does that mean  
13      that the paragraph in the OFT's *Mergers-Jurisdictional and*  
14      *Procedural Guidance* that essentially talks about the  
15      European first-past-the-post rule that has aligned with  
16      the EC, which I gather is in the pipeline, is to be  
17      removed from the final product?

18     MR SCOLA: That is right. As I mentioned to Gavin Robert, we put  
19      out the consultation on the J&P guidance because we looked  
20      at the European Commission system and thought there was  
21      great merit in having that certainty in terms of  
22      predictability, but on further reflection, taking account  
23      of the response to the consultation, we do not think it  
24      aligns very neatly with the reference test.

1 MR PRITCHARD: The approach on failing divisions sets a slightly  
2 hushed tone in the sense that it is characterised as being  
3 more likely to be exceptional. I understand the reasons  
4 behind that, but based on decisions in practice I think  
5 there have been more failing division clearances at phase  
6 one than entire failing firms. I was wondering whether  
7 there is a conscious shift to set the bar a little higher  
8 for a failing division than a failing firm.

9 MR SCOLA: I do not think so. What it reflects is evidential  
10 caution which is that you can have a successful business  
11 turning up at the door and saying that inevitably it would  
12 exit a particular line of business for whatever reason.  
13 Some caution is required before you accept that too  
14 easily. I take the point about some of the cases to date,  
15 although obviously it is a fairly small sample set.  
16 Therefore, it is probably fair to revisit the question  
17 later. I believe that the caution in the guidelines is  
18 more to do with the evidence that we shall be looking for  
19 in terms of the inevitability of that exit. If that is a  
20 business decision you will be looking at something that by  
21 its nature is not too constructed and appears to run deep  
22 and true.

23 MS HADDEN: I entirely agree with Nick. That was something we  
24 looked at very carefully in the Long Clawson/Millway

1 merger where an otherwise profitable firm overall had a  
2 division that we found was failing. We looked carefully at  
3 what the incentives were to make sure there was no  
4 possibility that turnover was being manipulated in any way  
5 as between businesses within the group and it was  
6 genuinely the case that this business satisfied the  
7 criteria of failing and there was no possibility that  
8 restructuring, which is particularly key in the context of  
9 a division rather than a firm, would solve the problem.  
10 Those cases are the exception rather than the rule, but in  
11 any case they will be looked at very carefully in terms of  
12 the available evidence.

13 CHAIRMAN: Are there any further questions? If not, we will move  
14 on to my favourite subject: market definition. I should  
15 say that the guidelines published so far have benefited  
16 from consultation from some distinguished academics. We  
17 also held two round tables with other distinguished  
18 academics. They have been round various government  
19 departments and have benefited from comments by DG Comp,  
20 so they are not just the work of the OFT and CC. The  
21 process is ongoing.

22

1 MARKET DEFINITION

2  
3 MR FINER: Amelia mentioned that the main change in the  
4 guidelines was to downplay market definitions, so I hope I  
5 am suitably low key and downbeat about the whole thing. In  
6 any case, we shall not talk about the role of market  
7 definition which may be picked up in the discussion of  
8 competitive effects; rather, we intend to focus on just  
9 the main developments in terms of process within the  
10 guidelines. To this end, first Nicola will give a broad  
11 overview of how we think the hypothetical monopolist test  
12 should be applied and then I shall pick up a few other  
13 aspects in slightly more detail.

14 MR MAZZAROTTO: Thinking about the hypothetical monopolist test,  
15 I guess *these* are the things that we would flag up by way  
16 of overview of how we look at the implementation of this  
17 methodology for the purposes of market definition. I would  
18 pick up a couple of broad themes. The first is one that  
19 ensures consistency with the rest of the competitive  
20 assessment; it is not just unilateral effects but co-  
21 ordinated effects despite what is written in the slide.  
22 The point here is that we want to make sure we can use a  
23 methodology not just to address competition that takes  
24 place with respect to price but more generally the

1 competition that takes place with respect to other  
2 competitive variables. As we have said many times already  
3 today, this is one of those examples where it is not  
4 really evolution in practice; it is merely clarification  
5 or formalisation of existing practice. Cases as far as  
6 back as Zeiss/Bio-Rad in 2004 and more recently  
7 Boots/Alliance Unichem before the OFT in 2006 have really  
8 used the hypothetical monopolist test as a conceptual  
9 framework that applies, certainly to the case of  
10 Zeiss/Bio-Rad, to research and development but can be  
11 applied also to other dimensions such as quality and  
12 service which are seen as equally important.

13 The other aspect that we sought to clarify is the  
14 treatment of the different constraints from demand and  
15 supply side substitution. Amelia mentioned this at the  
16 beginning. I am sure that it can be seen to be placing  
17 different emphasis on the two. I believe that what drove  
18 us at least to begin with to think about a slightly  
19 different way of doing things was mainly the fact that we  
20 thought this provided a framework that would give us the  
21 flexibility we needed to deal with constraints  
22 particularly from supply side substitution that could be  
23 dependent on things fairly specific to the firm, such as  
24 the ability and incentive it might have to switch to the

1 production of a good. That makes that type of constraint  
2 fairly different from a demand side constraint where all  
3 that is required is just a switch from consumers to a  
4 competitive product and there is intrinsic immediacy in  
5 the availability of the product to consumers to begin  
6 with.

7 Because this is a slightly different approach I  
8 thought I would have a go at some things that pop up on  
9 the slide. *Here* we follow an example that we use in the  
10 current guidance. The starting point is to have some  
11 product. The example we use is one involving liquid egg  
12 producers which has been encountered in a recent OFT/CC  
13 merger. Those products are identified in red; the stars  
14 indicate the firms that produce liquid egg. The green ones  
15 indicate firms that produce fruit smoothies. You will  
16 appreciate instinctively—that is one of the good things  
17 about this example—that if you want to get some liquid egg  
18 probably fruit smoothies are not an intuitive demand side  
19 substitute. It is probably even more intuitive if you  
20 start with the fruit smoothie: you would not want some  
21 liquid egg in it or instead of it.

22 Starting from this point, we believe that we shall be  
23 defining the relevant market by reference to those demand  
24 side substitutes. Therefore, we would call it the market

1 for liquid egg. We stress that this does not mean that the  
2 constraints from supply side substitution are ignored;  
3 rather, they will be considered on their merit. We will  
4 not seek to conduct an analysis that is too crude in terms  
5 of just looking at the cost and time taken to switch but  
6 really we will consider for each individual firm where are  
7 the incentives and ability for it to switch. As firms can  
8 have different technology these may be quite different.  
9 Assuming that those incentives are different for the two  
10 groups of firms closest to the liquid egg producers and  
11 they would have the incentive and ability to switch to  
12 counter a price increase of the type involved in the  
13 hypothetical monopolist test then that is the way in which  
14 we would identify the set of competitors. That set of  
15 competitors would then feed into the construction of a  
16 market share and would be used for the assessment of both  
17 unilateral and co-ordinated effects.

18 MR FINER: That is the broad application of the hypothetical  
19 monopolist test. There are a few other smaller areas in  
20 the guidelines that are possibly slightly different from  
21 the previous CC guidance and I should like to focus on a  
22 couple of those.

23 First, there is a paragraph in the draft guidelines  
24 that rather downplays the role of chains of substitution

1 in market definition. We do not think this is any grand  
2 revolution but that a properly applied hypothetical  
3 monopolist test will take into account the sorts of  
4 considerations you would think about when defining a chain  
5 of substitution and breaks in that chain. I do not believe  
6 that is a big deal but it is a change.

7 Second, we hope that we have made a little clearer  
8 our position on the cellophane fallacy in the current  
9 guidelines. What we want to emphasise is that our usual  
10 starting point will be the prevailing price in defining a  
11 market in a merger investigation. However, what we have  
12 done is to leave open the possibility that we may need to  
13 be aware of the cellophane fallacy where we believe there  
14 may be co-ordinated effects in the market. The reason for  
15 this is that if we did not take the cellophane fallacy  
16 into account there would be a danger of overlooking the  
17 potential harm of a merger between already co-ordinating  
18 firms because we might think that they were operating in a  
19 wider market.

20 If there is a loss of competition moving from a  
21 collusive outcome with some potential instability to all  
22 of that market now being held within a single merged firm  
23 that is something of which we need to be aware.

1           We have also made more explicit our position on  
2 asymmetric constraints in the current draft guidelines.  
3 Here the idea is that your starting point in the  
4 definition for the hypothetical monopolist test matters.  
5 For example, in mergers of grocery retailers you may have  
6 two small stores merging in a market which also includes  
7 large stores. The flip side is that a merger between two  
8 large grocery stores may not include small firms within  
9 that relevant market.

10           The next point is: multi-sided markets. Amelia  
11 referred to recognising complications. For example, one  
12 has the situation where newspaper providers target two  
13 audiences: readership and advertisers. The relationship  
14 between the two is important. The externality of the  
15 effect of a change in readership on what you can command  
16 in terms of advertising revenue is an important  
17 consideration. I believe that the market definition  
18 section of the draft guidance recognises this as an issue.  
19 It does not present some generalised model of how we will  
20 deal with all the complications; it just recognises that  
21 it is there and it is something we must think about.

22           Finally, there is a section on secondary product  
23 markets. This is basically imported from the existing OFT  
24 guidelines on market definition, but it recognises that

1 the interrelationship between primary and secondary  
2 products is important when analysing a merger between two  
3 such providers. For example, if you have two firms that  
4 provide the servicing of a particular type of helicopter  
5 the purchasers of that item take into account the  
6 servicing when they buy it. That puts you in a position  
7 that is different from the situation where they do not do  
8 so. Therefore, you have to take into account all these  
9 different factors.

10 CHAIRMAN: Are there any questions on market definition?

11 MR ROBIN NOBLE (Oxera): I was very interested to note that you  
12 adopted a 5% SSNIP test as opposed to what I believe was a  
13 mixed message previously where one guideline referred to  
14 5% to 10%. First, why have you focused specifically on one  
15 number? Second, why is that number 5% rather than, say,  
16 10%?

17 MR FINER: My understanding is that we have not adopted 5%.

18 Everybody is scrabbling for the relevant paragraph.

19 MR MAZZAROTTO: I think that is right. If that is so it must  
20 have been a last-minute printing mistake. I hope we have  
21 not made it.

22 MR NOBLE: It is paragraph 4.55 on page 25: '. . .the  
23 Authorities will normally apply a price increase of 5 per

1 cent whilst assuming that all other prices remain  
2 unchanged.'

3 MR MAZZAROTTO: If you continue reading there is the 'however'  
4 bit which our lawyers assured us was a very important  
5 paragraph. The idea is that we want to give a sense of  
6 what the practice is like. In run-of-the-mill cases in a  
7 typical scenario 5% has been used as the default, if you  
8 will, but I think that the key principle here, as we say  
9 at the end of that paragraph, is that we would make a  
10 judgment as to what constituted a small but significant  
11 price increase and that might well be different depending  
12 on the market we are considering.

13 MR NOBLE: It strikes me that there are several readers at Oxera  
14 all of whom independently came up with this and said, 'Oh!  
15 It's now 5% rather than 5% to 10%.' That would indicate to  
16 me that words matter here and that using the nomenclature  
17 of 5% to 10% might be quite important, if that is the  
18 wiggle room you are intending to use. If you think about  
19 the learning from behavioural economics and the way people  
20 respond to surveys, it is much easier to ask someone about  
21 10% than about 5%, but if what you are really concerned  
22 about is a small price change—obviously, 5% is a lot  
23 smaller than 10%—it could have a significant bearing on

1 the way people run surveys and this is analysed in  
2 practice. That is perhaps something to think about.

3 CHAIRMAN: We will take that away. It was an area where the  
4 guidelines as between OFT and CC were different. Are there  
5 any more questions? If we have exhausted the audience on  
6 market definition no one will be happier than I.  
7 Otherwise, I congratulate you on your low-key  
8 presentation. Let us move on to the next topic.

9  
10 **UNILATERAL EFFECTS**

11  
12 MR WALTERS: I note that in an almost unprecedented departure by  
13 OFT and CC we are running substantially ahead of schedule.  
14 I suppose that that leaves two alternatives: first, that I  
15 talk about unilateral effects for half an hour; second,  
16 that we finish a bit earlier and leave more time for  
17 questions.

18 CHAIRMAN: Or you can go by the accurate clock down the end!

19 MR WALTERS: I will just pick a clock at random and leave more  
20 time for questions and then we can go for refreshments a  
21 bit early.

22 As Amelia mentioned, the concept of unilateral  
23 effects is one that is very well developed in merger  
24 analysis. Consequently, in this area there has been little

1 change from what is in the existing guidelines. However,  
2 there is a new structure in terms of the way we think  
3 about not just unilateral effects but also co-ordinated  
4 and non-horizontal effects which stresses theories of  
5 harm. Although that structure pervades all analytical  
6 areas of the new guidelines its impact is perhaps most  
7 clearly seen in the analysis of unilateral effects. The  
8 idea is that that new structure is used to categorise  
9 existing indicators of unilateral effects. Those  
10 indicators exist in one form or another in both sets of  
11 guidelines, but the idea is that the structure can tell  
12 you for a given kind of merger which indicator is more  
13 probative of unilateral effects than another.  
14 Consequently, there is less emphasis on market definition  
15 in the way the section on unilateral effects is drafted.

16 We think that the unilateral effects of a horizontal  
17 merger are the same regardless of whether that merger is  
18 framed as one generating high concentration in a narrowly  
19 defined market or as one between closer competitors in a  
20 more broadly defined market. Consequently, the previous  
21 emphasis on having a definitive statement about market  
22 definition is not really there in the current draft of the  
23 guidelines. We make the point that in certain cases we can  
24 back into market definition from the competitive

1 assessment. In cases where you look at the effect of the  
2 merger on competition you consider the closeness of  
3 competition that is removed. Sometimes you can back into a  
4 market definition from that particular approach and the  
5 guidelines make that point.

6 The guidelines also make the point that the OFT and  
7 CC will be concerned primarily with the unilateral effects  
8 on customers of one or both of the merger firms but may  
9 also be mindful of the effects on other firms in the  
10 market. In particular, I think the authorities will be  
11 more mindful of merger effects on the customers of one or  
12 both of the merger firms where the merger is between  
13 producers of differentiated products. The authorities will  
14 be more concerned about what happens to the merged firms'  
15 customers but may also be mindful of the ripple-through  
16 effects on parts of the market.

17 The more structured framework that I discussed is  
18 illustrated here. It is almost like an intellectual flow  
19 chart. You begin by considering what parameters of  
20 competition and aspects of competition are important and  
21 what strategic weapons the firms use to compete with each  
22 other. These can be price and short-term non-price  
23 factors: quantity, range, service and quality. Medium-term  
24 non-price factors would be, for instance, product variety;

1 or there can be longer-term non-price factors such as  
2 innovation or capacity expansion.

3 The authorities will look for aspects of competition  
4 that are relevant to the merger and in the light of those  
5 they will go on to look at the nature of competition over  
6 those competitive aspects and parameters. To pick a couple  
7 of well-known examples, if we were to find that the merger  
8 involved firms where short-run price or quantity-setting  
9 behaviour was particularly important we would postulate  
10 the nature of competition with the familiar Cournot and  
11 Bertrand models which are the work horses of unilateral  
12 effects analysis.

13 Having identified the aspects of competition and its  
14 nature and worked out which economic models to use, we  
15 would then formulate our theories of harm which I rather  
16 dramatically put in the star in the middle of slide. No  
17 doubt that is some sort of hawkish Freudian slip. On the  
18 basis of those theories of harm we would look at what  
19 indicators of unilateral effects are relevant. I have  
20 given some examples of indicators of unilateral effects.  
21 They also exist in both sets of guidelines in one form or  
22 another, so they have been brought together in the hope  
23 that this structure will help to categorise indicators  
24 showing which ones may be more probative of unilateral

1 effects in which type of merger. Reading down from the top  
2 we have: market share, firm numbers, fascia counts,  
3 closeness of competition in particular as measured by  
4 diversion ratios, the number of alternatives that  
5 consumers can switch to and the switching costs involved  
6 in so doing. Next we have the question whether or not  
7 rivals are easily able to react and whether the merger  
8 involves a recent entrant or a firm that is in some sense  
9 a novel competitor. Those indicators exist but the  
10 structure serves to indicate we hope which are more  
11 relevant for which kinds of mergers. In the remaining part  
12 of the presentation I shall just talk through a few of  
13 those in a bit more detail.

14 Our guidelines emphasise that market shares are most  
15 informative for mergers in undifferentiated product  
16 markets, that is, industrial-type mergers. The guidelines  
17 have abolished the CC's 25% threshold. I put 'safe  
18 harbour' in inverted commas because, as I am sure you  
19 know, it was not actually a safe harbour per se. The  
20 presumption was that mergers generating combined market  
21 shares of less than 25% would be unlikely to give rise to  
22 a presumption of an anti-competitive effect. However,  
23 without making that stronger statement in the guidelines  
24 based on OFT's previous decisional practice and our

1 analysis of essentially all phase one mergers since the  
2 start of 2006 we say that unilateral effects are unlikely  
3 below combined market shares of 40%.

4 To move on to firm numbers, we explain how and why we  
5 would use fascia counts in particular mergers, for example  
6 mergers of retailers in multiple local geographic markets  
7 and what kind of intervention threshold we might set. We  
8 emphasise that the closeness of direct competitive  
9 constraints removed by the merger is most informative for  
10 mergers of differentiated products. In some cases market  
11 definition can be very complicated and perhaps resources  
12 that could be put into market definition are best used for  
13 directly assessing the degree of competitive constraint  
14 that is removed by the merger.

15 We mention diversion ratios. Some of the text  
16 mentions a number of ways in which you can look at  
17 diversion ratios which have been used in previous OFT and  
18 CC merger inquiries. We go on to outline the role of the  
19 combination of diversion ratios and profit margins as a  
20 gauge of the upward pressure on prices.

21 I'll turn briefly to the list of other indicators.  
22 Consistent with what is already in the OFT and CC  
23 guidelines we mention that lack of alternatives for  
24 consumers to switch to can be probative of a merger giving

1 rise to unilateral effects; for example, they can arise  
2 because of switching costs. We mention that unilateral  
3 effects theories of harm are often predicated on a lack of  
4 reaction by rivals. Some of the models of competition that  
5 I mentioned earlier essentially presume that rivals do not  
6 react when the merged firm internalises the competition  
7 between the two merger parties and does something  
8 anti-competitive. We mentioned in our guidelines that  
9 firms can undercut price, expand output in  
10 undifferentiated product markets or reposition products in  
11 differentiated good markets which is a form of efficiency.  
12 In instances unilateral effects will be more likely where  
13 firms are not able to react in that way, but we mention  
14 that unilateral effects will be less likely where firms  
15 are able to react to that.

16 The last of our indicators is that a merger involving  
17 a recent entrant or particularly aggressive or novel  
18 competitor could potentially be more problematic. In terms  
19 of the economics this is an indicator that to some extent  
20 is *sui generis* but it is quite well reflected in  
21 decisional practice. That is all I have to say about  
22 unilateral effects. Are there any questions?

23 MR WILLIAM SIBREE (Slaughter & May): I should like to ask the  
24 OFT members of the panel whether this shift from market

1 definition focus in differentiated product markets is now  
2 being reflected in the sort of evidence that is now being  
3 asked for routinely in phase one cases.

4 MR WALTERS: That is probably a fair point. There are delegates  
5 here who are probably better placed to answer that  
6 question than I am. It is not that we necessarily subsume  
7 market definition in horizontal mergers of differentiated  
8 goods, but certainly it is not the be all and end all and  
9 when it appears that the merger involves very  
10 differentiated products other evidence, qualitative and  
11 quantitative, of the closeness of competition that is  
12 removed by the merger is something on which we concentrate  
13 nowadays, and I think that is reflected in our recent  
14 decisional practice.

15 MR SIBREE: If there are not such serious issues quite a heavy  
16 burden is imposed on notifying parties if they have to go  
17 through the whole business of getting robust econometric  
18 evidence of diversion ratios.

19 MR WALTERS: The evidence needs to be robust but it does not  
20 need to be econometric. There are other sources of this  
21 kind of information including internal documents prepared  
22 in the normal course of business that can be tremendously  
23 informative about the closeness of competition between  
24 merger parties and other rivals.

1 MR SIMON BISHOP (RBB Economics): I do not have a question but  
2 really a comment. One of the very first assignments I had  
3 in competition law was related to an OFT market definition  
4 research paper in 1992, I think. That was set out because  
5 they wanted to remove 'ad hockery' in market definition  
6 and by imposing the principles of the hypothetical  
7 monopolist or SSNIP test that went a long way to remove a  
8 lot of the sub-sub-market definitions which were seen in  
9 OFT and Monopolies and Mergers Commission decisions. I  
10 think there is a real danger in reintroducing 'ad  
11 hockery'. The real issue is that you are mischaracterising  
12 the problem. The problem is not with market definition per  
13 se. The SSNIP test itself is very well able and is  
14 designed to cope with differentiated product markets. The  
15 issue is concerned with the interpretation of market  
16 shares. If you say that you do not need to do market  
17 definition and you just jump to the answer because  
18 otherwise you are wasting your time you are creating the  
19 real probability that you will ignore really important  
20 competitive constraints in the assessment. It is one thing  
21 to say that the market shares associated with the  
22 particular firms are overstated. Fine, but tell me why and  
23 where it comes from, because the current approach and what

1       you are advocating raise a serious problem in terms of an  
2       incomplete analysis and an ad hoc one.

3 MR WALTERS: I do not believe that my earlier statement that it  
4       should not matter whether you frame a merger as one  
5       generating high concentration in a narrow market or as one  
6       between close competitors in a wider market, for the  
7       purposes of unilateral effects analysis, is a  
8       controversial one. I think the implication of it is that  
9       there is a duality between the things. There is a duality  
10      between measures of the closeness of competition and  
11      their application in a SSNIP test and that duality has  
12      been reflected in the kind of the critical loss analysis—I  
13      am sorry to slip into jargon—for market definition that  
14      the OFT has done in some recent decisions. I do not think  
15      that in what we are doing we are abandoning the  
16      hypothetical monopolist test as a tool for the competitive  
17      assessment of mergers. What we are recognising is that  
18      there is an interrelatedness between measures of the  
19      closeness of competition and the application of the SSNIP  
20      test. In those contexts if the route that leads you to  
21      apply the SSNIP test is very convoluted and complicated  
22      perhaps you should look at the flip side of the coin and  
23      exploit the duality to focus on the closeness of  
24      competition.

1 MR BISHOP: I do not want to monopolise the whole debate, but  
2 another point is that even on your own analysis you have  
3 market shares for competitors and a load of other factors  
4 which are all presumed market definitions, so what you  
5 intend to do is move from an explicit market definition to  
6 an implicit one. Effectively, by doing that you are in  
7 danger of ignoring some important competitive constraints  
8 or not explaining why they are not there. From a practical  
9 perspective it is just good discipline to take that step.

10 MR WALTERS: I did say in the market share numbers slide that we  
11 agreed market shares were most informative for mergers in  
12 undifferentiated product markets, but the application of  
13 the SSNIP test can be more complicated in mergers  
14 involving very differentiated products and in recognising  
15 the duality between the two approaches it is perhaps more  
16 prudent to apply the latter approach in those mergers than  
17 to take a rigid market-definition/market-share approach. I  
18 genuinely do not believe there is any tension there.  
19 Provided you identify the aspects of competition and the  
20 mode of competition in the market that describes those  
21 properly and use that to categorise the evidence you are  
22 asking for to my mind the two approaches are not  
23 inconsistent.

1 CHAIRMAN: Does anybody else want to come in on that? From my  
2 perspective we are definitely not trying to jettison  
3 market definition or the need to define markets—far from  
4 it. There is a big discussion in the guidelines about  
5 market definition. If we were dropping it and going back  
6 to random analysis we would not have such material in the  
7 guidelines. What we are talking about is how we apply it,  
8 in what order the various steps of the analysis take place  
9 and how it is all knitted together. It is important not to  
10 overstate the extent of the evolution.

11 MR JOHN COLLINGS (CC Member): I think that in the draft  
12 guidelines the point is made that in a sense there is a  
13 difference in this respect as to whether we are heading  
14 towards an SLC or non-SLC finding. In a sense with a non-  
15 SLC finding you are more likely to go down the road of  
16 saying that the exact market definition does not make a  
17 difference. I think that survived in the guidelines.

18 MR MAZZAROTTO: Given the effort that we put into making sure  
19 our market definition methodology was one on which we  
20 could rely to use market share as an appropriate way of  
21 taking into account constraints on the supply side I think  
22 it goes some way to reassure everyone that we do not  
23 intend to do away with the process which, as you say, is  
24 good discipline. We all agree that it is good discipline

1 to make sure decisional practice is consistent with the  
2 SSNIP test methodology. It is a matter of recognising that  
3 there are different sources of evidence and to ensure that  
4 that consistency is true we want to ensure we take into  
5 account all of the evidence that comes out of the  
6 competitive assessment and do not apply in a mechanistic  
7 fashion one or two-step procedure based on relatively  
8 limited bits of information. We are just trying to do it  
9 well, we hope.

10 CHAIRMAN: Does anyone else want to comment on unilateral  
11 effects which are the killing ground for most merger  
12 investigations? This is the central core of the  
13 guidelines. Ominous silence! Does anybody else want to say  
14 anything by way of explanation? I would be a little  
15 concerned if it was thought that the purpose of the  
16 revised formulation was to take away certainty and lay us  
17 open to suggestions that it would not be possible to  
18 predict how the analysis would go. That is absolutely the  
19 reverse of the intention. We have come some way since  
20 1992. I remember that time fondly. Some aspects have  
21 become more certain and others less so but on the whole  
22 the technique of analysis of these competitive effects  
23 becomes much more sophisticated. It is possible to be much  
24 more certain about how a particular analysis will be

1 carried out. I think you should see this very much as a  
2 comparatively modest de-emphasising of a mechanistic  
3 approach to market definition. I rest my case.

4 MS DEIRDRE TRAPP (Freshfields Bruckhaus Deringer LLP): Leaving  
5 aside the great generation of work that the new approach  
6 will create for GfK and their friends in the world of  
7 surveys, will we get a little more clarity on how surveys  
8 are to be done and when they are to be relied upon by both  
9 agencies? A number of us have experiences of surveys being  
10 done on which the OFT has relied heavily but have not met  
11 CC's expectations. I think it would be useful if we had a  
12 bit more information in that capacity.

13 MR WALTERS: As I understand it, the CC currently has a working  
14 group looking at best practice on consumer surveys and  
15 other quantitative techniques. I must emphasise that  
16 consumer surveys are not the only way to get estimates of  
17 diversion ratios. The CC working party is looking at that  
18 kind of best practice. Perhaps Nicola can tell you a bit  
19 more about it.

20 MR MAZZAROTTO: One thing to note is that perhaps there is an  
21 element of trying to apply some methodologies at phase one  
22 with some survey work to see if they work, but the field  
23 of surveys is not one where we can rely on a very clearly  
24 established practice from a theoretical and empirical

1 point of view. We are striving to get to a place where we  
2 can be a little clearer in terms of what can be done when  
3 and under what conditions. We are working towards that.  
4 Whether or not we can build that into the guidelines is  
5 something to be seen, but it is fair to say that we shall  
6 be thinking about this.

7 CHAIRMAN: This falls fairly and squarely into the category of  
8 getting the right allocation of tasks between the two  
9 phases. We must be aware that this is a dynamic,  
10 evolutionary process. The cry from business, as we  
11 understand it, is that what can be done at phase one  
12 should be done. The two authorities have obviously  
13 discussed that and are not unsympathetic. There is a  
14 danger of trying to do too much at phase one and getting  
15 these techniques right and having clarity about the kind  
16 of evidence that is appropriate, of which surveys are one  
17 part, is part of the ongoing process. All I would say is  
18 that this is something about which we are in discussion;  
19 this is what we are consulting on and we shall listen  
20 carefully to any feedback.

21 MR PETER DAVIS (Deputy Chairman, CC): First, there is ongoing  
22 work within the CC to have a go at answering what are some  
23 quite difficult questions about exactly how we get the  
24 most reliable evidence on SSNIP and questions like it on

1       which we are focused. Second, both the CC and OFT are  
2       dedicated to get both the existing learning in the  
3       respective organisations across the organisations and also  
4       to take on any new learning and imbed it in both  
5       organisations so we are not in a situation where evidence  
6       accepted at one stage is not acceptable at another.  
7       Clearly, that is not the right outcome. We shall be  
8       working to make sure that that is not the situation,  
9       subject to the usual concerns. Obviously, the CC has more  
10      time to look at these things than the OFT.

11 CHAIRMAN: Unless there are any other questions, I suggest that  
12       we break for a quarter of an hour. Perhaps we can  
13       reassemble at quarter to four by the accurate clock.

14 **REFRESHMENT BREAK**

15 CHAIRMAN: We turn to the next topic.

17 **CO-ORDINATED EFFECTS**

18  
19 MR BOWDEN: As you have probably deduced already, I am from the  
20       legal side of the room. If I was not aware of the debate  
21       that co-ordinated effects induced in economists, it was  
22       definitely brought home when I read the 101-page  
23       transcript of the OFT/CC round table discussion on the  
24       subject. From what I could deduce it seemed to me that

1 certain things were agreed and there were a number of  
2 areas where there was disagreement as to whether there  
3 would be any agreement at all. What we had to do was take  
4 that round table and put it into our co-ordinated effects  
5 section. Nicola will talk about the round table and what  
6 we ended up putting into the guidance and I will just do a  
7 quick run-through on some of the UK and overseas decisions  
8 in relation to co-ordinated effects. The point to note  
9 about the UK merger situation is that there have not  
10 really been many co-ordinated effects cases. Since the  
11 Enterprise Act the CC has not reached any SLC finding  
12 based on co-ordinated effects although some cases have  
13 been referred to it by the OFT based on co-ordinated  
14 effects theories of harm. In many cases the OFT has left  
15 open the issue of co-ordinated effects for the commission  
16 to consider. There are really only three cases: Bricks,  
17 Cardboard and Sugar where the commission has undertaken a  
18 detailed co-ordinated effects analysis, although  
19 ultimately the co-ordinated effects theory of harm was not  
20 found to exist in any of those cases. In developing the  
21 new draft guidelines we definitely reflected on some of  
22 the overseas guidance and developments in recent cases,  
23 most notably the Impala decision, ABF/GBI and recent cases  
24 in the US. What those decisions show is that to establish

1 co-ordinated effects is not particularly easy and the  
2 authorities need quite a coherent framework by which to  
3 assess all the evidence, including both market conditions  
4 and outcomes. I do not think there is the clear structure  
5 that was being debated in relation to unilateral effects.

6 As Amelia pointed out, there is a broad formulation  
7 of co-ordinated effects although in different cases they  
8 were worded slightly different. We thought that we would  
9 word it slightly differently ourselves. Nicola will go  
10 into some of the background of how we set out our  
11 formulation.

12 One thing that the two European cases provided was a  
13 useful overview of the structure of a co-ordinated effects  
14 analysis. In the ABF case DG Comp notes that the first  
15 step is to consider market conditions to determine whether  
16 they are conducive to tacit co-ordination, but it cautions  
17 against a mechanistic approach to looking at these market  
18 conditions. Therefore, you need to articulate a story  
19 surrounding the likely mechanism for tacit co-ordination  
20 and the likely degree of co-ordination that can be  
21 expected in the absence of the merger. Finally, you need  
22 to assess how the merger will make co-ordination either  
23 more likely or effective, so you need to consider what  
24 change the merger will make to the other two factors. I

1 will pass you over to Nicola to give you a bit more  
2 background.

3 MR MAZZAROTTO: We have mentioned the round table a couple of  
4 times. The transcripts should still be on the CC/OFT  
5 website for your perusal. What we shall not attempt to do  
6 is summarise the round table as a whole, even less  
7 summarise the very rich and varied literature on the topic  
8 in terms of practice, economic theory and the empirical  
9 studies that have been conducted over the years. There are  
10 some themes that we think it important to highlight that  
11 arise from the round table in particular to help shape the  
12 way we ended up drafting the consultation document. What  
13 we learned from the round table was that, first, this is a  
14 relatively new area in terms of theory, certainly if we  
15 compare it with some aspects of unilateral effects theory  
16 that go back to the 19<sup>th</sup> century, but on the plus side  
17 aspects of this theory are relatively well accepted and  
18 have performed well in practice. I am thinking primarily  
19 about the theory of incentives to co-ordinate that forms  
20 the basis for the necessary conditions for co-ordination  
21 to take place; in other words, economics have been able to  
22 provide a helpful way to assess whether and under what  
23 conditions firms will find it in their interests to adhere  
24 to a co-ordinated agreement or not. From that theory we

1 derive the conditions which are the same as those used in  
2 various jurisdictions which can also be known as the 'Air  
3 Tours conditions'.

4 The other thing to note which clearly emerges from  
5 the round table is that the theory on co-ordinated effects  
6 is different from that on unilateral effects in some  
7 important respects. It does not really address some of the  
8 issues that are relatively important to the finding of the  
9 case which is the process of reaching an agreement. It is  
10 often said it is important to look at all of the evidence  
11 that is available in that respect and not to conduct it in  
12 terms of some perhaps slightly esoteric theoretical  
13 economic arguments.

14 The other point is the need to recognise that it is  
15 not a binary (in/out) strategy; it is not a question of  
16 moving from zero co-ordination to full co-ordination.  
17 The reality of co-ordination is more complex than that and  
18 co-ordinated outcomes can differ in terms of the  
19 likelihood with which they will be sustained over time and  
20 the price level they are able to sustain. It is important  
21 that this variability of outcomes is recognised when one  
22 comes to assess the effects that a merger can have on  
23 prices or other variables that consumers then have to  
24 face.

1           In simple terms what the theory does not do is  
2 provide the same level of simple rules with respect to  
3 market shares, for example, which we call comparative  
4 studies. Unless the models are very specific and detailed  
5 and therefore lose a little bit it is very difficult to  
6 derive some general rules about higher market shares being  
7 necessarily bad. That is why other issues such as symmetry  
8 and generally seeing everything in the round is such an  
9 important part of the assessment that we try, successfully  
10 we hope, to incorporate in our draft.

11           The general point that emerges from some of these  
12 issues is that the way to assess the validity of co-  
13 ordinated effects theory of harm is by reference to a  
14 fairly well developed story of how co-ordination will take  
15 place in practice. It is not enough to refer to co-  
16 ordination in the abstract; there needs to be some sense  
17 of what competitive variables it would be affecting.  
18 Clearly, that changes the way in which one would treat  
19 some of the elements of the evidence. One example is the  
20 role of symmetry. If you think about co-ordination in  
21 terms of market sharing, for example geographical market  
22 sharing, you may think differently about how important it  
23 is that firms are of a similar size or have a similar  
24 level of output or even costs in reaching your conclusion.

1           Bearing these things in mind, we think that the  
2 framework we set out is very much in line with  
3 international practice and is the one that Amelia set out  
4 earlier in her slides. It is helpful to consider *these*  
5 conditions. At the points of the triangle you have the  
6 necessary conditions for co-ordination to occur in a  
7 market. Clearly, in terms of analysing a co-ordinated  
8 effects case if those conditions are met then the issue  
9 becomes whether the merger can ensure that those  
10 conditions are met in the post-merger scenario. If they  
11 are then the issue becomes whether the merger makes co-  
12 ordination more stable and easier for firms to reach a  
13 higher level of price or they can co-ordinate better from  
14 the point of view of other aspects of the offer. As Amelia  
15 said, in terms of reach and monitoring co-ordination it is  
16 helpful to look at that in the context of the ability of  
17 firms to engage in co-ordination.

18           As to internal stability, we have in mind the  
19 incentives to adhere to the agreement, in particular  
20 whether there is a deterrent mechanism and what happens if  
21 a firm deviates from the co-ordinated outcome. In a sense  
22 it covers the issue of incentives. Finally, the condition  
23 of external stability is whether the co-ordination would  
24 have an effect, that is, whether they would be able

1 | meaningfully to co-ordinate to worsen the competitive  
2 | outcome in some shape or form. Essentially, what that  
3 | means is assessing whether the co-ordinated firms as a  
4 | whole have enough market power to wield in the market;  
5 | that is, whether entry constraints could be expected to be  
6 | strong enough essentially to undermine any co-ordinated  
7 | effort.

8 |         What we sought to recognise in our guidance is the  
9 | fact that there are some scenarios where we believe on the  
10 | basis of the theory in place and the empirical work that  
11 | has been done and the practice as it has accumulated over  
12 | the years it is probably important to recognise that there  
13 | are two scenarios where we would be particularly concerned  
14 | by a merger in terms of its ability to lead to co-  
15 | ordinated effects. One is the case where we believe that  
16 | in the market there has been a history of attempted but  
17 | not necessarily successful co-ordination. That is because  
18 | of the fact that co-ordinated outcomes are by their nature  
19 | always a little imperfect. It is often the case that  
20 | unless the merger leads to a situation where the  
21 | incentives are no longer aligned either because it raises  
22 | asymmetries in a very significant fashion or because of  
23 | other reasons it is likely that it will make co-ordination  
24 | stronger and more stable just by making the market

1 structure more symmetrical and reducing the number of  
2 competitors. The role of high concentration asymmetry is  
3 also one that we thought was important to recognise. When  
4 we get two markets where there are two or three firms that  
5 are fairly symmetric the risk of them being able to  
6 recognise their interdependence and align their behaviour  
7 in a way that reduces competition is a significant one.  
8 Under the heading we also pick up the danger of mergers  
9 that eliminate players. For example, a new competitor is  
10 sometimes called the maverick; it goes under that  
11 particular heading. I will leave it at this point. That is  
12 the general framework.

13 CHAIRMAN: Lots of guidance but rather few cases! Are there any  
14 questions or comments?

15 MR JEREMY SIMON (Norton Rose LLP): I just want to check whether  
16 the authorities have adopted a position where the three  
17 conditions are now not just necessary but of themselves  
18 sufficient. There is a statement in the guidelines that a  
19 merger in a market with two or three similarly sized firms  
20 in which the three conditions are met may well be  
21 considered to give rise to an SLC.

22 CHAIRMAN: What is the reference?

23 MR SIMON: It is paragraph 4.122.

1 MR MAZZAROTTO: I think that is one of the two situations where  
2 we try to highlight that fact. I do not think we are  
3 saying that they are sufficient. Clearly, we want to look  
4 at what the merger does to the market context, but if by  
5 looking at the post-merger scenario we are in a situation  
6 such as the one you describe as specified in that  
7 paragraph I think the message is that the reduction in the  
8 number of competitors and the increasing symmetry that  
9 that might bring about is something that we would take  
10 very seriously.

11 CHAIRMAN: It is clearly not a per se rule; the argument is over  
12 what is meant by 'may well' as opposed to 'may'. We  
13 encourage you to read 4.122 in context. Bearing in mind  
14 its position in the section on co-ordinated effects as a  
15 whole I do not believe that the question you ask is our  
16 position. We may have to look at the wording just to make  
17 sure that we are not giving an erroneous impression that  
18 we are giving a 'tick in the box' approach.

19 MS FLETCHER: I think we are a little loose with our 'may well',  
20 'is likely to', etc. We need to go through the whole  
21 guidelines with this in mind.

22 CHAIRMAN: You will have a glossary at the back saying 'may  
23 well', and so on—or 'may not'?

1 MR SIMON BISHOP (RBB Economics): I have a question that relates  
2 to existing co-ordination. Given that a lot of market  
3 outcomes which might be consistent with existing tacit co-  
4 ordination can also be consistent with effective  
5 competition, it raises the difficulty of how to  
6 discriminate between those two outcomes. Are there any  
7 thoughts on how you would do that?

8 MR MAZZAROTTO: I will have a stab at that. That is clearly an  
9 important issue particularly in the context of the recent  
10 EC cases, in particular Impala. I do not think we have a  
11 clear set of rules as to how we go about doing that, but  
12 when we are thinking about evidence of pre-existing co-  
13 ordination we certainly do not have market outcomes as the  
14 sole matter we have in mind; indeed, we would be very  
15 careful in treating evidence about pricing or other  
16 evidence of market outcomes in isolation to draw an  
17 inference from that alone without making sure we had other  
18 forms of evidence to suggest that it is co-ordinated  
19 behaviour that we are talking about. It is one of those  
20 cases where we would be very careful in conducting an all-  
21 round approach.

22 MS FLETCHER: We were thinking more about explicit co-ordination  
23 in terms of evidence of pre-existing co-ordination. In  
24 that case we are thinking about explicit documentary

1 evidence, but even then it is very difficult. For example,  
2 we have had mergers where we have had leniency  
3 applications. Obviously, such applications are entirely  
4 confidential. We are then in a very difficult position. We  
5 think we know things on the basis of those leniency  
6 applications but we cannot necessarily make use of that  
7 information, so it is very tricky. Sometimes, counter to  
8 that, an industry has been through an entire cartel  
9 investigation, been found guilty, fined etc and then it  
10 says, 'Well, just because we did it in the past doesn't  
11 mean we will ever do it again. We've learned our lesson  
12 and you can't now stop us merging on the basis that in the  
13 past we engaged in that behaviour.' There are arguments in  
14 favour of that point as well. This is a very difficult  
15 area and we must see how we apply it in practice, but  
16 views are very welcome.

17 MR GAVIN ROBERT (Linklaters): I have a couple of comments on  
18 the first point raised by Simon. There was a very useful  
19 paragraph in the previous CC guidelines on the difficulty  
20 of distinguishing between competitiveness and co-ordinated  
21 outcomes. It is one that I have cited in several previous  
22 cases to various regulatory authorities, so if that is  
23 being purposefully deleted from my point of view that  
24 would be a shame.

1 CHAIRMAN: If it has been deleted by accident that is all right,  
2 is it?

3 MR ROBERT: The second point is on the relevance of previous  
4 cartel behaviour. I think that in various guidelines  
5 around the world this is thrown in as a relevant factor  
6 without any more sophisticated analysis of how you  
7 determine its relevance. I would argue that the existence  
8 of a previous cartel could be evidence of the unlikelihood  
9 of tacit co-ordination by the parties and you have to look  
10 at the individual cartel circumstances in order to reach a  
11 view on the relevance of the previous cartel. Therefore,  
12 if the previous cartel was one where they had specifically  
13 put in place illegal information-sharing mechanisms and  
14 some form of cartel manager to operate the cartel—because  
15 otherwise the market would be insufficiently transparent—  
16 that may be the best evidence you could get that the  
17 market is not susceptible to tacit co-ordination. I know  
18 there are lots of other guidelines around the world that  
19 make this statement which in some sense is a glib one  
20 without much more sophisticated analysis. It would be a  
21 shame if in looking at this area you did not engage in a  
22 slightly more sophisticated analysis of when cartel  
23 behaviour was and was not relevant.

1 MR MAZZAROTTO: We agree with that. I guess that is why those  
2 scenarios are in the middle of the triangle surrounded by  
3 those helpful conditions on the outside. This is very much  
4 something that we consider in the context of the overall  
5 assessment and certainly not in isolation. I take your  
6 point about the fact that explicit and tacit co-ordination  
7 are not necessarily substitutes.

8 CHAIRMAN: The paragraph you have in mind is 3.43, is it, which  
9 starts, 'However, identifying co-ordinated effects is  
10 difficult. . .'?

11 MR ROBERT: I do not have the reference.

12 CHAIRMAN: It is the old one; it is the last one.

13 MR ROBERT: I am afraid I do not have the reference in my head.

14 CHAIRMAN: I thought there was so much in the present  
15 formulation that makes it clear that identifying co-  
16 ordinated effects is difficult, but we will have a look at  
17 that to see whether or not we have the difficulty  
18 sufficiently clear.

19 MR JONATHAN GREEN (Europe Economics): Given the difficulty of  
20 reaching findings on co-ordinated effects and the  
21 variability of outcomes to which you refer, is there a  
22 danger of a type of Goodhart's law operating where if you  
23 do identify indicators that you think are useful in  
24 helping you to define the circumstances the very fact of

1 defining them means they become less valuable as  
2 indicators and the action moves elsewhere? Just because  
3 this is such a complex area maybe trying to get greater  
4 precision means that the life of competition authorities  
5 is made more difficult in the long term.

6 CHAIRMAN: I fear that is our burden. I am sure that as an  
7 observation that is very true. My impression is that our  
8 task becomes more difficult every week as we strive to do  
9 a better job, but I am afraid that is life.

10 MR MAZZAROTTO: That really lies behind our attempt to identify  
11 some scenarios where we think that on balance, not just on  
12 the basis of a few models of economic theory, looking at  
13 the practice and empirical evidence over the years  
14 everything that we know about co-ordinated effects tries  
15 to put us in a position to reach the right balance between  
16 being able to address those issues and building a case  
17 that stands up on the basis of the evidence. It is a  
18 difficult job.

19 CHAIRMAN: We will try to avoid 'ad hockery' anyway.

20 MR PETER DAVIS (Deputy Chairman, CC): I want to say a word  
21 about distinguishing co-ordination from competition. As  
22 many in the room will know, this is an active area of  
23 progress in the academic economics world. Some of the  
24 lessons have been brought into practice, some have not.

1 But as guidance for what we would do, let me say that we  
2 would take that fairly well understood broad branch of  
3 economics, starting off with the likes of Tim Bresnahan in  
4 the early 1980s and moving on through authors such as Rob  
5 Porter and more recently Pat Bajari and others. All of  
6 that work to ask the question: what is the data variation  
7 that allows you to distinguish competition from  
8 co-ordination? Some of the answers are not immediately  
9 obvious, for example the answers involve things like  
10 demand rotations. Nonetheless, that literature would be  
11 the basis of the effects-based economic analysis that you  
12 would undertake in a given case. Obviously, in the  
13 interpretation of the conditions and how that feeds into  
14 whether or not there is an SLC in a merger there will be  
15 elements of judgment as well, but the basic problem of  
16 distinguishing pricing patterns which are the result of  
17 competition and those which spring from co-ordination is a  
18 difficult but not impossible economic question on which  
19 data and theory can be brought to bear, and the match  
20 between the institutions on a given case and the theory  
21 obviously needs to be made clear.

22 For a survey there is a rather nice piece by Joe  
23 Harrington quite recently which looks at these branches of  
24 literature. Basically, that is what we would do; we would

1 look at the economics literature and take the lessons from  
2 it and use them to allow us to distinguish between co-  
3 ordination and competition to the extent we can. There are  
4 limits. There are some parts of that theory that are not  
5 yet well developed, but there are substantial areas of it  
6 which are now well-trodden territory.

7 MR ADRIAN MAJUMDAR (RBB Economics): Paragraphs 4.13 to 4.15 are  
8 intriguing. They start off by saying: 'The Authorities  
9 thus consider it is possible for a merger to lead to both  
10 unilateral and co-ordinated effects on the same aspects of  
11 competition.' For example, on price we could have a  
12 unilateral effect and a co-ordinated effect. It then goes  
13 on to say: 'The Authorities may not need to form a view of  
14 the likelihood of both theories of harm if they expect one  
15 of them to be sufficient.' I can understand why at the OFT  
16 stage you may have a view that both can be credible and  
17 therefore there is a referral issue. I am just wondering  
18 whether this suggests that at the stage of the Competition  
19 Commission it could be said, 'Well, there's a 30% chance  
20 of a unilateral effect and a 25% chance of a co-ordinated  
21 effect, so on balance that is a problem.' If not, what are  
22 the examples where both a unilateral effect and a co-  
23 ordinated effect occur?

1 MR MAZZAROTTO: First, what we mean in paragraph 4.13 is that if  
2 we expect one of them to be sufficient to meet the  
3 competition test that means, for example, we think it is  
4 more than likely that there will be unilateral effects.  
5 That is the likely scenario. We perhaps cannot rule out  
6 that there will be co-ordinated effects on top of that,  
7 but we think the likely scenario is unilateral effects. I  
8 think that is just there to say that we do not necessarily  
9 feel we have to form too narrow a judgment as to what we  
10 are able to predict in terms of the likely market outcome.  
11 What we need to show is that there is an expectation that  
12 there will be harm to consumers in one way or the other.

13 CHAIRMAN: That is absolutely right. We do not intend to play  
14 percentage gymnastics but to work out what would be the  
15 most effective and pragmatic theory of harm to  
16 investigate.

17 MS FLETCHER: Reading it, I do not think it is entirely clear  
18 and we should address that sentence, but we do not intend  
19 to say that the merger could result in both theories of  
20 harm on the same aspect as the same time. I think that  
21 what we mean to say is that some mergers could lead to  
22 either and it may not necessary for us to determine which  
23 of the two is the more likely if at least one of them is  
24 very likely.

1 CHAIRMAN: That is absolutely right. That was what I was trying  
2 to say very inadequately. Can we move on now to the last  
3 topic?

4  
5 **NON-HORIZONTAL MERGERS**

6  
7 MR WALTERS: Our guidelines on non-horizontal mergers are  
8 borrowed from the European Commission's excellent non-  
9 horizontal merger guidelines. Our guidelines recognise  
10 that the commercial rationale for non-horizontal mergers  
11 is generally efficiency enhancing. An exception here would  
12 be diagonal mergers which warrant only a brief mention in  
13 the guidelines. I believe they are quite novel and I will  
14 talk about them briefly at the end. However, what is  
15 unusual about recent UK case law is that many 'verticals'  
16 have been horizontal mergers with vertical effects; they  
17 have not been purely vertical mergers in the sense of some  
18 of the very high profile EC vertical mergers of recent  
19 years. Unlike purely vertical mergers and conglomerate  
20 mergers, these may not be naturally as efficiency  
21 enhancing, but set against that the focus of attention  
22 that we mention in our guidelines will be on the  
23 horizontal harm, not necessarily the vertical harm.

1           What has permeated the way we have written the  
2 guidelines on non-horizontal mergers is the lack of  
3 suitably general models of vertical and conglomerate  
4 foreclosure and that implies a need in some sense to  
5 future proof the framework, by which I mean that all non-  
6 horizontal mergers involve different markets that can have  
7 different modes of competition, which was part of the  
8 language I used earlier in the context of unilateral  
9 effects. These markets will have linkages between them.  
10 Therefore, the notion that there is some sort of very  
11 general model of non-horizontal mergers is not really as  
12 strong as it is when looking at horizontal models of  
13 competition and unilateral and co-ordinated effects. I  
14 think that implies in some sense a need to future proof  
15 the framework.

16           The framework we have chosen is the EC's ability  
17 incentive and effect framework but, unlike the quite well  
18 structured flow chart approach that I described under  
19 unilateral effects, here we have a Venn diagram. That can  
20 be contrasted with the much more structured flow under  
21 unilateral effects. As Amelia explained earlier, the EC's  
22 framework looks at ability which typically will depend on  
23 market power, which I shall go on to discuss; the  
24 incentive to foreclose in the vertical or conglomerate

1 sense, which will depend on whether such foreclosure is  
2 profit-enhancing; and the effect on competition, not just  
3 competitors, allowing for efficiencies.

4 Our guidelines also explicitly draw a distinction  
5 between the application of this framework at phase one,  
6 the OFT stage, and phase two. Given a realistic prospect  
7 of an ability to foreclose and a realistic prospect of an  
8 incentive to foreclose, the OFT may presume anti-  
9 competitive effects. The OFT may look at any form of total  
10 or partial input or output foreclosure or conglomerate  
11 effects tying or bundling and, if it finds a realistic  
12 prospect of the ability and incentive to do that, it may  
13 not necessarily need to say which of the particular forms  
14 of foreclosure it thinks is most likely but may presume an  
15 anti-competitive effect. Conversely, the CC will not do  
16 that. Notwithstanding the fact that it would not be bound  
17 by the OFT's finding under the realistic prospect test on  
18 ability and effect, the CC will instead attempt to look at  
19 what it thinks is the appropriate foreclosure strategy and  
20 then assess the effect of that strategy. Therefore, there  
21 is an explicit distinction in the guidelines between the  
22 first phase and second phase approaches.

23 Another sense in which we try to future proof the  
24 framework is by talking about things in the more general

1 sense, if you like in the Venn diagram sense. We have not  
2 said as much about non-horizontal effects per effect if  
3 you like as we have done about other effects. To give a  
4 simple example, the section in our guidelines on  
5 unilateral effects that I described earlier is five pages  
6 long; the section on co-ordinated effects is three pages  
7 long; and this section is seven pages long but it covers  
8 four different types of effect. Therefore, the 'per  
9 effect' wordage, if you like, is proportionate to the  
10 frequency with which these sorts of effects come up in  
11 case work.

12 To turn to ability to foreclose, typically this will  
13 depend on whether the merged firm has market power. Here I  
14 have highlighted a market share 'threshold'. In a purely  
15 vertical merger we have borrowed the European Commission's  
16 30% market share threshold, but we do not have as much  
17 emphasis on this as is in the Commission's non-horizontal  
18 merger guidelines. Moreover, we explicitly mention that in  
19 horizontal mergers with vertical effects, of which there  
20 have been a lot in the UK, only a degree of market power  
21 significant enough to cause unilateral effects will cause  
22 concern over vertical effects. That may not be 30%.

23 We also say that the ability to foreclose typically  
24 depends on whether or not the firm has market power and

1 that can arise because it controls an important input, so  
2 it is not just a simple measure of market share. We say  
3 that an important input is one that if foreclosed would  
4 adversely affect the competitiveness of the merged firms'  
5 rivals.

6 We go on to the second of the three circles in the  
7 Venn diagram: incentive. This depends on whether  
8 foreclosure is profit-enhancing. Whether or not that is  
9 the case depends on a trade-off between the profit lost  
10 from selling less in the market where the merged firm  
11 leverages its market power—so, in the case of input  
12 foreclosure that arises from selling less of the input; in  
13 the case of customer foreclosure it arises from selling  
14 less through this route to market; and in the case of  
15 conglomerate foreclosure it arises from selling less of  
16 the tying good because people prefer not to buy it as part  
17 of some sort of bundle—and, on the plus side of the  
18 ledger, the profit gained from selling more/at a higher  
19 price in the market where the merged firm forecloses its  
20 rivals. We explicitly discuss that trade-off. However, our  
21 guidelines have a limited role for what is called  
22 'vertical arithmetic' especially at first phase, but we  
23 use those aspects heuristically in the guidelines. Part of  
24 the reason we have a limited role for vertical arithmetic

1 is that the factors that go into the very literal  
2 arithmetic calculation hold true only in quite a small  
3 number or cases. We appeal to the intuition of the  
4 vertical arithmetic but what we do not do is emphasise it  
5 particularly strongly as an analytical approach.

6 Referring to the last circle in the Venn diagram-  
7 effect-as Amelia explained earlier this is the effect on  
8 competition, not on one or just a few competitors. As I  
9 explained, given the incentive and ability the OFT may  
10 presume effect. It may look at a range of foreclosure  
11 strategies. If it finds incentive and ability it may say  
12 that one or more of those may have an anti-competitive  
13 effect. Conversely, the CC will not do that. Not only will  
14 it not take the OFT's findings on ability and incentive as  
15 given; it will instead look at what it thinks is the  
16 appropriate foreclosure strategy and assess the ability,  
17 incentive and effect of that strategy. Recognising that in  
18 both the first and second phase approaches non-horizontal  
19 mergers are often efficiency-enhancing, there is always a  
20 role for supply-side efficiencies, subject to the normal  
21 evidential threshold for efficiencies: that they are very  
22 likely to arise and will be timely, by which I mean they  
23 are commensurate with the onset of any harm; that they are  
24 merger-specific; and that they are passed on to customers.

1           To mention the extra single paragraph on diagonal  
2 mergers, essentially in our guidelines we characterise it  
3 as a vertical merger that is not as likely to give rise to  
4 efficiencies. Just to give you a practical example of what  
5 I am talking about—I am grateful to Mark Williams of NERA  
6 for suggesting it to me—the vertical merger here involves  
7 a sugar beet farm which supplies beet to be refined and  
8 the refined beet sugar then competes in the market with  
9 refined cane sugar. An increase in the sugar beet price  
10 can therefore increase the demand for refined cane sugar.  
11 A diagonal merger between the sugar beet farm and the  
12 sugar cane refinery indicated by the dashed line could  
13 therefore internalise this competition. This will have an  
14 anti-competitive effect only if: sugar beet is a very  
15 important input to refined beet sugar, which it probably  
16 is in this particular example but need not be all the  
17 time; the sugar beet farm has market power; and refined  
18 beet sugar and cane sugar compete very closely, which  
19 again in this example they probably do, but this need not  
20 always be the case. I do not want to over-emphasise  
21 diagonal mergers but it is new and there is a paragraph in  
22 the guidelines about that.

23           That is the end of my brief tour of non-horizontal  
24 mergers.

1 CHAIRMAN: Are there any comments on that aspect or non-  
2 horizontal mergers generally?

3 MR JONATHAN GREEN (Europe Economics): For clarification, you  
4 mentioned the 30% 'threshold' for vertical links. One of  
5 the earlier slides in the section on unilateral effects  
6 talked about a 40% share where problems may start to  
7 arise. I was not quite clear from what you said how the  
8 two were related.

9 MR WALTERS: They are related in the sense that in a purely  
10 vertical merger we do not have a horizontal concentration.  
11 There has been no assessment of market power at the  
12 horizontal level, so, borrowing from the Commission's non-  
13 horizontal merger guidelines, we say that it is not very  
14 likely that we will find market power in that purely  
15 vertical sense unless one of the firms has a 30% market  
16 share. Conversely, we say in the section on horizontal  
17 unilateral effects that in cases where there is a  
18 horizontal merger previous decisional practice of the OFT  
19 suggests that unilateral effects are less likely with  
20 combine market shares of 40%. I think you are right to  
21 point it out. We do not know whether or not there is some  
22 tension there, but in the context of the 40% share that  
23 would be a horizontal merger with vertical effects. The  
24 30% share in this instance would be a purely vertical

1 merger, but we did discuss whether there was value in  
2 harmonising in some sense those share thresholds. You will  
3 remember that in the section on unilateral effects we say  
4 we are less likely to find harmful effects below 40% but  
5 we certainly would not rule that out. Here we are being  
6 more generous to purely non-horizontal mergers where you  
7 do not have the horizontal effects at all.

8 MR ROBIN NOBLE (Oxera): I make a comment specifically about  
9 this session but perhaps it goes a little broader as well.  
10 In formulating these guidelines there is a tough trade-  
11 off. You want them to be relevant and draw on best  
12 practice as informed by cases, but you also want it to be  
13 long lasting, so the question that struck me as I was  
14 reading the document and also listening to these sessions  
15 was whether or not what we have here is a very fashionable  
16 document—certainly, diagonals are very fashionable—but the  
17 question is: will that be a timeless classic or consigned  
18 to the flares of history, as it were?

19 There are a couple of things floating around in my  
20 head both from reading and what I have heard today. One  
21 is: where are we going with market definition? This is a  
22 slight departure from the historical path for the past few  
23 years. Referring to earlier comments, it strikes me that  
24 there are a lot of very recent cases in there. Naturally,

1 one will refer to recent cases but one wonders whether we  
2 should have a few more classics, if one can really call  
3 cases 'classics'? Is it the right length? Is it too long?  
4 Maybe it is. Classics are often quite short. Maybe it does  
5 need that length to go into the depth and detail required  
6 to explain the complexities of what is going on, but, as  
7 you have said, sometimes it is better to say little or  
8 nothing at all because the debate is ongoing and if one  
9 pins one's colours to the mast too early one may come to  
10 regret it. It is a thought on which I have not really  
11 reached a conclusion, but I wonder whether it is something  
12 that can be ruminated upon by the panel.

13 CHAIRMAN: We will ruminate. The next question will probably be  
14 the last.

15 MR DAVID PARKER (Frontier Economics): I have one question on  
16 market share thresholds. In the guidance it seems that you  
17 have a 30% share in one market as a minimum before you  
18 start to become concerned, but is there not also a role  
19 for a share threshold in the other market in that your  
20 concern is that a reasonably strong position in one market  
21 may lead to a diminution of competition in another? If you  
22 have only 1% or 2% in that other market do you really want  
23 to go into lots of complicated vertical thresholds? Should

1 we not have a further threshold to screen out those sorts  
2 of cases?

3 MR WALTERS: The answer to that is yes. It is not described as a  
4 market share threshold but there needs to be enough of a  
5 market presence in the market that is being foreclosed so  
6 you enjoy enough diversion to your products in that market  
7 to make it worthwhile to foreclose. That is not expressed  
8 in terms of a market share threshold but that is the  
9 underlying logic. You need a sufficiently significant  
10 presence that if you foreclose the product you pick up the  
11 business to make that worthwhile.

12 MR MAZZAROTTO: That may not necessarily be something you are  
13 able to assess on the basis of pre-merger shares. I guess  
14 there must be an expectation that you will gain in the  
15 downstream market from your foreclosure strategy. That is  
16 not necessarily something you can always deduce from your  
17 pre-merger share by definition. That is what you are  
18 trying to ameliorate in a sense.

19 MR PARKER: It is surprising to me that you would not feel  
20 comfortable with a *de minimis* threshold of, say, 5%.

21 MS FLETCHER: That is something we should think about. I know  
22 that it is also being thought about in respect of the  
23 vertical guidelines under 81. Part of the reason for the  
24 30% test here is for consistency with those guidelines.

1 Obviously, if they are to end up with market shares at  
2 both levels then possibly it makes sense for us to look at  
3 the same thing. We will take that away.

4 CHAIRMAN: It is after half-past four and I think I shall draw  
5 this to a close. First, I thank our presenters and  
6 analysts for taking the time and effort to explain to you  
7 some of the thinking behind the guidelines. I also thank  
8 you for turning up, listening and engaging in the  
9 consultation. We carefully note the queries and points  
10 that have been made. We were trying to stress that this is  
11 a genuine consultation. The fact that it is a joint  
12 publication we regard as very valuable. We have agreed on  
13 the text which in itself is, we hope, a considerable help  
14 to the marketplace. There are various areas where OFT and  
15 ourselves will do things in slightly different ways. That  
16 reflects our different timing and slightly different  
17 tasks. We shall take away and consider the various queries  
18 that have been raised: the significance of being first  
19 past the post; the point about the percentage threshold  
20 for the hypothetical monopolist test; the danger of moving  
21 too far away from a market definition and framework and  
22 towards arbitrary and unpredictable analysis; increased  
23 emphasis on survey work at phase one, and whether this  
24 fits in with the allocation of tasks; the difficulties

1 involved in co-ordinated effects; greater clarity in  
2 relation to cartel behaviour; how we tell the difference  
3 between competition and co-ordination; and the fact that  
4 we would not aim necessarily to apply both theories of  
5 harm in relation to unilateral and co-ordinated effects to  
6 the same situation at the same time.

7 As to the question raised at the end about whether  
8 this document is too long, whether it is a classic and  
9 whether it is intended to be set in concrete, the answer  
10 is clearly no and that is how it should be seen. We have  
11 had guidelines since 2003. The first guidelines were  
12 written on the basis of no directly relevant case  
13 experience at all, so all the cases and doctrines are by  
14 analogy with previous practice or the practice of other  
15 authorities. We have since had six years of actual  
16 experience and we can hardly be blamed for sprinkling a  
17 few recent cases. If you regard six years as 'recent' then  
18 all cases are recent by definition. We are sprinkling a  
19 few of those around in order to help the reader relate  
20 these rather abstract propositions to some real material.

21 I hope we have emphasised in the accompanying  
22 material—I certainly do so again if it is called for—that  
23 this is an evolving picture; it is a fluid document. We  
24 will publish new ones from time to time, but practice

1 evolves and we have to keep our guidelines up to date. The  
2 CC like the OFT has a constant process of going over each  
3 aspect and testing them against current practice, problems  
4 and issues and seeing whether or not they hold water.  
5 Inevitably, what you get is an attempt to update the  
6 previous volume and in turn it will be updated surely. I  
7 do not think we are trying to enact now guidelines for the  
8 next 50 years; to do that would be hopelessly optimistic.  
9 It is meant to be a living document. As to whether it is  
10 too long or too short I leave to you. It is a thundering  
11 good read, particularly if you suffer from insomnia.

12 On that note, thank you very much and goodbye.

13 *(Applause)*

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