

## MEMORANDUM

### **LECG comments on 'Review of Merger Assessment Guidelines: A joint publication of the Competition Commission and Office of Fair Trading consultation,' Draft of 14 April 2010**

#### **Introduction**

LECG welcomes the opportunity to comment on the April 2010 draft of the Competition Commission (CC) and Office of Fair Trading (OFT) joint Merger Assessment Guidelines. Having commented on the previous draft for consultation issued in April 2009, we reiterate our commendation for the collaboration between the CC and the OFT to produce a single set of merger assessment guidelines. LECG is pleased to note that the latest draft appears to have absorbed, in some form or other, many of the comments we had made on last year's consultation document, notably with regard to the following issues:

- Conglomerate mergers have been subsumed under the header of non-horizontal mergers and are now dealt with more briefly, reflecting the relative rarity of concerns arising in the context of such concentrations;
- An explicit distinction is now being drawn between own-price elasticities on the one hand, and cross-price elasticities and diversion ratios on the other (see ¶4.63);
- In relation to supply-side substitution, the new draft guidelines emphasise the need to establish that the companies have the ability and incentive quickly to shift capacity between different products (see ¶4.67);
- There is recognition of the fact that it is the switching cost relative to the value of the product, not the absolute switching cost, that matters (see ¶4.71);
- It is acknowledged that identifying coordinated outcomes on the basis of pre-merger outcomes (e.g., prices, market shares) may be difficult, because, whilst coordination may result in price parallelism, intense price competition often also does (see Footnote 60).
- The new draft guidelines clearly distinguish between the analysis of total and partial foreclosure, recognising that the former can have much more serious effects than the latter. (see ¶4.139).

We note, in particular, the fact that the present draft guidelines reinstate the traditional role of market definition as a useful tool in determining the competitive constraints on merging parties. As pointed out in our comments on the 2009 draft, which downplayed the role of market definition, the process of market definition is a methodical way of identifying all of the supply-side and demand-side constraints on the merging parties. Where the process does not lead to a sufficiently clear outcome, this should be reflected

in a particularly careful treatment (e.g., robustness tests) of concentration measures derived.

Below we set out a number of remaining or additional comments on the April 2010 draft guidelines. We hope that those comments will assist the CC and OFT in preparing subsequent drafts.

### **Counterfactual**

- With regard to assessing whether a firm is failing, we recognise the need for the Authorities to consider the extent to which the firm is able to meet its financial obligations in the near future and to restructure itself successfully (¶4.30). We also acknowledge that this requires the Authorities to examine the firm's balance sheet to determine the profile of assets and liabilities (¶4.31); as well as – in the case of a potentially failing division of a firm – the allocation of costs within a business. However, the focus on such accounting measures should be secondary to the more critical determinants of long-term economic viability. To assess economic viability, not only current actual cash flows should be taken into account, but a view should also be taken as to the likely development of cash flows going forward, and whether this development warrants keeping a firm or division alive.
- We also note that the Authorities consider that '*[t]he possible unwillingness of alternative purchasers to pay the seller the asking purchase price would not rule out a counterfactual in which there is a merger with an alternative purchaser*' (¶4.33). This suggests that the Authorities are able readily to detect cases in which a transaction has not taken place only because of an 'exaggerated' asking price. We would welcome further clarification by the Authorities on the methodology it would apply to identify such cases.
- Furthermore, in ¶4.36, the draft guidelines state that where, absent the merger, the exit of the firm and its assets is inevitable, the Authorities will consider whether and how sales would have been redistributed among the firms remaining in the market. It would be helpful for the Authorities to indicate possible criteria that they might apply in doing so (e.g., market shares, diversion ratios based on elasticities etc.).
- One question raised in our comments on the 2009 draft guidelines that remains open is the treatment of two parallel transactions, each which individually would not give rise to an SLC, but raise a concern in combination. We would welcome clarification on the Authorities' position in such a case, in terms of which of the two transactions would have priority over the other when considering the counterfactual and competitive assessment.

### **Market definition**

- Concerning the hypothetical monopolist test, we suggest to replace the term 'reliable' in last sentence of ¶4.58 with the term 'conservative'. The reason is that, we believe, one would choose a narrow market definition for market share not necessarily because it is more accurate but because it is more conservative to do so. Moreover,

we would welcome some guidance on how the Authorities would decide as to the circumstances under which they would deviate from setting a SSNIP of 5% (¶4.59).

- Whilst references to the cellophane fallacy that were present in the 2009 draft have been omitted from the present draft guidelines, they state in ¶4.60: *'In most cases, a hypothetical monopolist test would be conducted relative to prevailing prices. In cases where it is thought that prevailing prices might be the outcome of coordinated behaviour, the Authorities may consider conducting the test using prices lower than prevailing prices as a starting point.'* We would welcome clarification by the Authorities as to how such lower prices would be determined.
- According to ¶4.75 and ¶4.76, the Authorities may sometimes define relevant markets for separate customer groups. Such markets may be narrow where, *inter alia*, suppliers are able to identify customers whose willingness to pay is high. We would welcome the inclusion of a brief discussion of the potential limitations to the ability of suppliers to identify such customers and the implications of those limitations for market definition. As the literature has shown, even relatively modest restrictions to the ability to identify the less price-sensitive customers may undermine the profitability of targeted price increases and hence the delineation of markets based on price discrimination (see, e.g., Jerry A. Hausman, Gregory K. Leonard, Christopher A. Velturo, "Market definition under price discrimination", *Antitrust Law Journal*, Vol. 64 [1996]).
- In ¶4.78(c), the draft guidelines note that concentration measures will be given less weight if there is evidence of turbulence in concentration (e.g., movement in market shares). We understand that heavy fluctuations can be generated, e.g., by 'lumpy' sales, but in our view this is an issue that may be addressed by using long-term average market shares. As a general point, one could also argue that high variability in market shares provide strong evidence in support of the existence of competition, and it may, therefore, not be justified to discount such evidence.
- Despite the Authorities' protestations in ¶4.79 that they do not employ any 'safe harbour' level of any concentration measures below which competition concerns may be ruled out, the subsequent reference to various previous OFT decisions nevertheless give the impression that such 'safe-harbour' thresholds continue to be in place. We would welcome more clarity on this issue.

### **Unilateral effects**

- As pointed out in our comments on the 2009 draft guidelines, the Authorities should seek to understand the strategic variables on which the firms compete and the frequency of competitive interaction. Different economic models of competition can predict drastically different effects, depending on the choice between price, quantity and/or capacity quality, innovation etc. We would welcome an explicit consideration of the differential impacts a merger may have in those various contexts.

## Coordinated effects

- In ¶4.121, the guidelines mention that inelastic demand makes deviation less likely because demand will not change much if price is lowered. However, by the same token it means punishment is less effective. As such it is not clear that elasticity of demand should overall affect the likelihood of collusion either way.

## Entry

An assessment of entry should consider the product lifecycle i.e. whether the market is expanding or contracting.

Further, it is not clear why the guidelines state “*the Authorities will evaluate whether entry is likely to take place at pre-merger prices*” (¶4.187). If entry would occur at pre-merger prices, it would have already happened. The economic question is whether entry would occur in response to a price increase, to mitigate the effects of the price increase. Entry doesn't need to be sustained if prices subsequently fall; the threat of entry can be sufficient to constrain prices.

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