

Review of the draft joint Merger Assessment Guidelines of the CC and OFT

Comments from Alistair Lindsay¹

1. Introduction and General Comments

1.1 I welcome the opportunity to provide comments on the draft joint Merger Assessment Guidelines of the CC and the OFT dated April 2009 (“**the draft Guidelines**”).

1.2 In general, there is much to welcome in the draft Guidelines. First, it is helpful that the documents issued by the Authorities following the Enterprise Act are being updated to reflect experience and developments. Secondly, it is valuable that the Authorities have identified common ground on many issues (which ought to ensure consistency between the two bodies) and have articulated the issues on which they intend to take a different approach. Thirdly, the draft Guidelines themselves are instructive from a practitioner's perspective, in particular because they include not only a description of the principles that the Authorities will apply but also checklists of categories of evidence that, if available, is likely to prove probative.

1.3 The remainder of this document identifies a number of areas in which the draft Guidelines should, in my submission, be amended or refined. I have not repeated those comments that were made at the seminar of 1 June 2009 with which I agree. The comments split into two categories. The first category comprises specific comments on the material that was included in (or omitted from) the draft Guidelines (section 2). The second category can be described as “systemic coherence” points: there are two areas in which the draft Guidelines articulate in uncontroversial terms the general principles to be applied, but other parts of the draft Guidelines are not consistent with those general principles. This applies to the standard of proof and the counterfactual (i.e. causation) (sections 3 and 4).

1.4 The contents of this submission are not confidential.

2. Specific Comments

2.1 In paragraph 3.33, the draft Guidelines state that, when applying the share of supply test, it is not necessary for the “substantial part of the UK” to constitute an undivided geographic area, implying that two or more separate areas could be treated together for these purposes. It would be helpful if the Guidelines were to confirm that two or more separate areas would be treated together only if both parties were making supplies (or purchases) in each of those areas. In particular, I can understand why the share of supply test could be satisfied if the merging parties are both active in several non-contiguous areas, none of which separately is a “substantial” part of the UK. However, the share of supply test should not be applied to “grab” jurisdiction entirely artificially, e.g. by saying that one of the merger parties has a 30 per cent. share in Somerset and the other has a 30 per cent. share in Cheshire, implying that they have a combined share of 25 per cent. or more in “Somerset plus Cheshire” even

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though there is no overlap in either county and the merged group's share would be below 25 per cent. in any continuous area containing both Somerset and Cheshire.

2.2 In Part 4.A (paragraphs 4.3 to 4.7) the draft Guidelines consider the question, "What is an 'SLC'?" The curiosity about this section is that there is no discussion of the meaning of "substantially".² The approach in the draft Guidelines could be defended on the basis that "substantial" is an ordinary English word, that should bear its ordinary meaning and requires no gloss. However, it seems to me that it would be informative for merging parties and practitioners (and good discipline for the Authorities) to add a paragraph explaining when a lessening of competition will be regarded as "substantial". Such a paragraph might make the following points (no doubt, amongst others):

- (a) in one sense, all horizontal mergers lessen competition because they remove an independent competitor;
- (b) however, the removal of an independent competitor does not in itself give rise to a substantial lessening of competition;
- (c) a substantial lessening of competition arises when the merger gives rise to a material harm to consumers;³
- (d) as explained in the remainder of the Guidelines, the loss of a competitor will not have such an effect if consumers are protected from material harm by other actual or potential rivals, their own buyer power or other features of the market;
- (e) there is no threshold of "acceptable" price rises that may occur as a result of the merger without giving rise to a "substantial" lessening of competition;
- (f) however, it is implicit in the general use of a 5 per cent. threshold in the SSNIP test, that a price rise of 5 per cent. would amount to a "substantial" lessening of competition.⁴

2.3 When the draft Guidelines introduce coordinated effects as a theory of harm in paragraph 4.11 they refer to "tacit collusion" and, in footnote 25, comment that "tacit ... collusion may involve actions that are illegal under competition law". It may be useful here to separate more clearly two distinct theories of harm. The first is coordinated effects in the *Airtours* sense which arise when, without any actions that infringe competition law (and in particular without any illegal contact or collusion between competitors), some or all of the players in the market reduce the intensity of competition to the detriment of consumers through actions which depend for their commercial success on an accommodating reaction from rivals. When discussing such coordinated effects, use of the phrase "tacit collusion" is liable to confuse because it tends to suggest that there has been some form of secret contact between suppliers. Moreover, the essence of such coordinated effects is that they do not infringe competition law, and therefore can be controlled only through merger control (or, in the UK, a market investigation). The second theory of harm is that the merger makes an unlawful cartel easier to operate or more likely to arise. Such a theory of harm will not often arise in practice, because if the Authorities are aware of the existence of a cartel, then it is likely either to have been brought to an end or the OFT will be able to bring it to an end fairly promptly by carrying out site inspections (which generally lead to the collapse of the arrangement).⁵ The upshot is that this

² There is an oblique reference in paragraph 4.14 to the fact that several theories of harm which, considered separately do not give rise to an SLC, may do so when considered together.

³ Contrast the more tentative formulation in paragraph 4.5 of the draft Guidelines.

⁴ The implication arises because there would be little point in defining the SSNIP test generally with reference to a 5 per cent. price increase if the Authorities did not intend to intervene in mergers to monopoly in a market defined using the SSNIP test (absent especial circumstances, such as low barriers to entry in a new or contestable market).

⁵ Moreover, in considering whether the merged group will engage in unlawful behaviour in the future, paragraph 4.167 of the draft Guidelines is applicable.

second theory of harm is a relevant theory of harm, but it should not be conflated with coordinated effects in the sense described above.⁶ This implies that paragraph 4.11⁷ of the draft Guidelines should be amended to refer to “coordinated effects” (removing references to tacit collusion) and footnote 25 of the draft Guidelines should make clear that coordinated effects involve conduct that is not an infringement of the Competition Act.

- 2.4 In footnote 33 to paragraph 4.40, the draft Guidelines state: “Strictly speaking, a parallel transaction does not form part of the counterfactual given that it will occur whether or not the merger proceeds.” The counterfactual is defined as “the situation likely to arise if the merger did not take place”.⁸ This means that a parallel transaction that will occur whether or not the merger proceeds falls squarely *within* the definition of the counterfactual, and it is potentially confusing to state otherwise.
- 2.5 In footnote 42 to paragraph 4.52, the draft Guidelines state: “The hypothetical monopolist test is used to identify constraints on the ability of the hypothetical monopolist that arise because of demand-side substitution.” This note implies that the SSNIP test is *not* applicable to the assessment of supply-side substitution. It should be clarified that the SSNIP test is used in assessing each of demand- and supply-side substitution.
- 2.6 In paragraph 4.75, when considering market definition, the draft Guidelines state that in intermediate markets in which prices are negotiated bilaterally, “it might be more appropriate to assess constraints by directly assessing the determinants of bargaining strength rather than conduct a standard SSNIP test analysis.” This is potentially confusing: the SSNIP test provides a conceptual clarity to the process of defining markets, but in many cases there is not sufficient evidence for it to be applied as a formal test, as the draft Guidelines themselves make clear in paragraph 4.52. When prices are negotiated bilaterally, the SSNIP test may well be impossible to apply as a formal test, but its value as an intellectual discipline remains. If the SSNIP test were disregarded in this context, the draft Guidelines should explain how one would assess the determinants of bargaining strength, and what criteria would be applied in determining the relevant market definition.
- 2.7 In section 4(b), “Measures of concentration” (paragraphs 4.84 to 4.93), the draft Guidelines treat market shares as a measure of concentration. This is curious, since measures of concentration generally seek to convey information about the degree to which production (or procurement) is concentrated in the hands of a few large firms, and they are generally thought of as separate from market shares.⁹ As explained further below in paragraph 2.8, these is a sense that the draft Guidelines are seeking excessively to downplay the role of market shares in unilateral effects analysis, and it may be that the absence of a separate section on the calculation of market shares (which merit less than seven lines of very tentative text – “can give an indication”, “can provide an indication” etc.) is part of that excessive downplaying.

⁶ If the approach advocated in the text is adopted, then the statement in paragraph 4.13 that a merger may lead to both unilateral and coordinated effects (which was discussed at the seminar) falls away: the OFT may identify a realistic prospect of both unilateral and coordinated effects occurring simultaneously, but the CC, applying its balance of probabilities standard, would not because unilateral effects are a measure of the merged group's power irrespective of the counter-strategies of rivals, whereas coordinated effects depend for their success on an accommodating reaction from at least some of the rivals.

⁷ See also paragraph 4.116.

⁸ Paragraph 4.9.

⁹ Indeed, paragraph 4.49 of the draft Guidelines refers to “market share and concentration” rather than, say, “concentration (including market shares)”.

- 2.8 The discussion of horizontal unilateral effects in paragraphs 4.99 to 4.112 seems to me to have become separated from the practical reality of merger analysis because of a wish to downplay the significance of market shares. I agree with the comment in footnote 88 that there should not be any “safe harbour” market share test, below which a merger will be approved. However, in practice, market shares perform a very useful role in identifying those markets which require more detailed analysis (and, indeed, they are used for this purpose – without creating safe harbours – in the case of vertical mergers in paragraph 4.141). I would have expected the draft Guidelines to include a paragraph along the following lines:

“When analysing unilateral effects in horizontal mergers, the Authorities will consider market shares as the first step in their analysis after identifying (credible candidate) markets. (As noted earlier, the OFT will take account of market shares of credible candidate markets, whereas the CC is more likely to reach a conclusive market definition when doing so is relevant to the analysis in the case.) In horizontal unilateral effects analysis (of both differentiated and undifferentiated products), the Authorities are unlikely to identify an SLC in a market in which the parties' combined share does not exceed 25 per cent. This is not an absolute rule (i.e. it does not give rise to a safe harbour), and there may be cases in which mergers involving lower shares may harm consumers materially, for example if the merged group is the largest player and there is a significant gap to the next largest supplier or if one of the merger parties exerts influence in the market that is disproportionate to its market share (e.g. because it is growing rapidly or its commercial strategy is beneficial to consumers and is different from those of all or most other rivals). Moreover, when the merger parties supply undifferentiated products, the Authorities are unlikely to identify an SLC in a market in which the parties' combined share does not exceed 40 per cent. Again, this is not an absolute rule (i.e. it does not give rise to a safe harbour) and there may be cases in which mergers involving lower shares may harm consumers materially, for example if rivals are capacity constrained. Mergers involving shares in excess of 25 per cent (differentiated products) or 40 per cent. (undifferentiated products) will not necessarily be referred by the OFT or found to give rise to an SLC by the CC, but they will be subject to very detailed analysis and, in particular, in the case of differentiated products, the Authorities will analyse very carefully the closeness of competition between the parties as explained further in paragraphs [4.102] to [4.104] below. (The use of market shares in the way described in this paragraph is not applicable in cases of coordinated effects.)”

If the final version of the Guidelines does not include a section along these lines, then (as was pointed out at the seminar by William Sibree of Slaughter and May and Deirdre Trapp of Freshfields) there is a risk that, in faithfully giving effect to the Guidelines, the Authorities will require merger parties to estimate diversion ratios and gross profits in all horizontal overlaps between differentiated suppliers which seems clearly disproportionate, especially since a survey is often the only practical way of estimating diversion ratios.

- 2.9 In discussing mergers between suppliers of differentiated products, the draft Guidelines emphasise the evidential value of high diversion ratios and high gross margins as a strong indication of unilateral effects in paragraph 4.104. This emphasis is, of course, reflected in a series of recent OFT cases. This methodology is very attractive from a theoretical perspective, but surveys can give anomalous results (whether because of the difficulty of answering hypothetical questions, gaming by

respondents or otherwise)¹⁰ and opinions can differ radically on the allocation of costs when calculating gross margins and on whether margins are “high”. It is important that there are clear guidelines for the carrying out of surveys (I appreciate that the CC is examining this issue) and the calculation and use of gross margins. The concern, of course, is that undue weight is placed on methodologies that produce a numerical outcome, when the outcome is only as good as the quality of the data that is input.

- 2.10 In discussing loss of potential competition as a theory of competitive harm in paragraphs 4.108 and 4.109, the draft Guidelines do not describe the principles that the Authorities will apply in assessing whether a loss of actual or perceived potential competition will give rise to an SLC. It would be very useful if the draft Guidelines were expanded on this issue.
- 2.11 When discussing evidence of pre-existing coordination for the purposes of coordinated effects, the draft Guidelines state at paragraph 4.120 that “Past cartel actions and proceedings in the same product market (in the UK or elsewhere) may also indicate that the conditions for coordination were met in that market.” It may be useful to expand this observation. In particular, if the parties formed a cartel in the past because coordinated effects (i.e. obtaining some or all of the commercial benefits of operating a cartel without infringing competition law) were impractical (which is, rationally, the only commercial reason to operate a cartel) then the existence of a previous cartel is evidence that, at the time of the cartel, the conditions for coordination were *not* met in that market. However, previous cartel activity in a market where the conditions for coordination were not met may result in the conditions for coordination being met for the future because the participants can, for example, use the reference point agreed during the cartel meetings as the reference point for coordinated effects. Equally, it is possible that parties formed a cartel even though coordinated effects were possible in the market (for example out of a feeling of insecurity or a wish for greater certainty) and the existence of a previous cartel is therefore perfectly consistent with the conditions for coordination being met.
- 2.12 The discussion of portfolio effects as a distinct conglomerate theory of harm in paragraph 4.156 and 4.160 is confusing. In particular, I suggest that the draft Guidelines are amended to make clear that:
- (a) if customers value variety then a merger which results in a supplier offering greater variety is, in general, to be welcomed;
 - (b) similarly (and in contrast to paragraph 4.160) a merger which lowers the merged group's fixed costs is, in general, either neutral or beneficial to consumers; and
 - (c) the fact that the merged group has a broader variety of products and/or lower costs gives rise to concerns only if the merged group has the incentive and ability to leverage market power in one of the markets into a second with anticompetitive effects for consumers through tying, pure bundling, full line forcing, exclusive dealing, cross-subsidisation, predatory pricing and/or the control of information.
- 2.13 When describing the principles applicable to new entry, the Guidelines state, at paragraph 4.187: “In assessing the likelihood of post-merger entry, the Authorities will evaluate whether entry is likely to take place at pre-merger prices. The reason for

¹⁰ For example, in *Home Retail / Focus*, the OFT relied in several important respects on what was referred to as “the February survey” but as regards Hull/Willerby, “The OFT questioned the probity of the February survey in this location because it showed a surprisingly low diversion ratio from Homebase to Focus (0 per cent), even though Homebase is geographically the closest store to Focus (notwithstanding that B&Q is the closest store to Homebase).”

this is that the objective of entry analysis is to assess whether entry is likely to prevent prices from rising following the merger; the only entrant who would be able to constrain prices to pre-merger levels are those who would find it profitable to operate in the market at pre-merger prices.” The first sentence of this quotation is (subtly) wrong, but the reasoning in the second sentence is correct. The issue is whether, if the merged group sought to raise prices above the level that would have prevailed in the absence of the merger, that attempt would be defeated by entry that drove prices back down to the level they would have been in the absence of the merger. In deciding whether to enter, a potential entrant would take into account the fact that its entry would (in most markets) drive down the market price. It is therefore unduly demanding to ask – as the draft Guidelines do – whether entry would take place at pre-merger prices. Indeed, one could ask in response why, if entry were attractive at those prices, nobody had done it. This implies that the first sentence should be re-written as: “In assessing the likelihood of post-merger entry, the Authorities will evaluate whether, if prices rise following the merger, entry is likely to occur that would reduce prices to [the pre-merger level] [the level that would have prevailed in the absence of the merger].”

- 2.14 In paragraph 4.204, the draft Guidelines state that, if efficiencies are to be taken into account in applying the SLC test, they must arise “within a period of time corresponding to the onset of any potential adverse effects on customers”. This requirement seems unduly demanding. In particular, a merger to monopoly would be approved if it can be shown that entry would be timely, likely and sufficient to counteract the harm that would otherwise arise as a result of the merger. For these purposes “timely” is generally taken to be two years. This implies that the merger that will result in short run harm to consumers would nevertheless be approved. It is not clear why a more demanding standard is applied if the analysis turns on efficiency arguments as opposed to new entry.

3. The Standard of Proof

- 3.1 The draft Guidelines state in section 2 that the OFT will refer a case when it believes there is a realistic prospect that the merger will result in an SLC (assuming that none of the exceptions to the duty to refer is applicable), but the CC applies a balance of probabilities standard asking itself whether it is more likely than not that an SLC will result. These statements are entirely uncontroversial.¹¹
- 3.2 However, the draft Guidelines depart from these general principles in several places, sometimes without a clear justification.¹²
- 3.3 When setting out the three conditions that are necessary for a finding of coordinated effects, the draft Guidelines state, at paragraph 4.118(c): “Coordination needs to be *externally* sustainable, in that there is little likelihood of coordination being undermined by competition from third parties.” This implies that if the prospect of

¹¹ In the light of the judgment of the Court of Appeal in *IBA Health Ltd v OFT* [2004] EWCA Civ 142.

¹² The draft Guidelines depart from the general principle when considering coordinated effects, but there seems greater scope to justify the position. More particularly, the draft Guidelines state, at paragraph 4.117, that a merger may give rise to an SLC if it makes coordination more likely or more effective. This raises the prospect that a merger could give rise to an SLC if coordinated effects were possible but unlikely prior to the merger (say 10 per cent. likelihood) and somewhat more likely after the merger (say 15 per cent. likelihood). Such a case might be cleared on the grounds that the lessening of competition is not substantial. But imagine in this case that the merger makes coordinated effects quite likely, but not so likely as to satisfy the balance of probabilities standard that the CC applies (say 40 per cent. likelihood). This is quite difficult: should the CC find that there is an SLC when it is more likely than not that customers will not suffer as a result of the merger? If coordinated effects are to be looked at applying a test of “on the balance of probabilities are coordinated effects more likely or more effective”, then should a similar test be applied to vertical and conglomerate foreclosure concerns if the concern is that the merged group may adopt a particular strategy, but it is unclear whether it would have an incentive to do so?

coordination being undermined by third parties is fairly likely (without meeting the balance of probabilities standard), then coordinated effects can be ruled out by the CC. It would be better not to include additional formulations of the standard of proof within the substance of the draft Guidelines, and this sentence could be re-written as: “Coordination needs to be externally sustainable, in that it will not be undermined by competition from third parties.” Such a neutral formulation means that the standard of proof at the OFT and the CC is then governed by the general statements in section 2 of the draft Guidelines that are quoted above.

3.4 In considering vertical and conglomerate effects, the draft Guidelines state (see paragraphs 4.145, 4.150 and 4.165) that if the OFT concludes that there is a realistic prospect that the merged group will have the ability and incentive to engage in a foreclosure strategy, then an adverse effect on consumers can be presumed. It is not clear why the OFT should proceed on the basis of a *presumption*, rather than analysing the issue. The most obvious justification for the use of presumptions is if they are very often correct *and* it would be very difficult or burdensome for the OFT to investigate the issue from scratch bearing in mind its limited time and resources. However, it is not evident that such a justification is available in this instance.

3.5 When describing the role of efficiencies, the draft Guidelines state, at paragraph 4.204, that “Efficiencies must be demonstrated to be very likely to arise” if they are to be taken into account in applying the SLC test. This appears to reflect a departure from the balance of probabilities standard that the CC generally applies, and it is not clear why this issue requires a different approach. Again, my submission is that the sentence should be rewritten as “Efficiencies must be demonstrated as arising as a result of the merger”, leaving the standard of proof to be read from the general provisions quoted above.

4. The Counterfactual / Causation

4.1 The draft Guidelines state, at paragraph 4.9, that the process of merger control involves a comparison of the prospects for competition with the merger against the competitive situation without the merger, i.e. the counterfactual. In other words, merger control involves assessing the change to the market brought about by the merger, and determining whether that change gives rise to an SLC. This is entirely uncontroversial. However, at two points, the draft Guidelines adopt a different approach to assessing the effect on competition that is caused by the merger.

4.2 The draft Guidelines state, at paragraphs 4.28 and 4.29, that one of the necessary conditions for the “failing firm” defence is that one of the merger firms would “inevitably” exit from the market in the absence of the merger. This means that if exit is “very likely” but not inevitable and the other conditions for the availability of the defence are satisfied, then the defence is not available. However, at the CC (applying the CC's balance of probabilities standard of proof) the counterfactual is that the merger firm would have exited and the merger does not cause an SLC.¹³ In this situation, would the CC nevertheless clear the transaction?¹⁴ Clearly, the policy justification for prohibiting the merger is that customers benefit from even a small prospect that the firm would have survived as an effective competitor, but the effect of adopting such a policy is to undermine the counterfactual as a coherent theme underpinning the merger control regime.

¹³ See paragraph 4.24 of the draft Guidelines.

¹⁴ At the extremes, imagine that the firm in question has enough cash to continue for one month, but has no other source of funding except that the sole proprietor buys a ticket for the National Lottery each week and would commit any winnings to funding the firm.

- 4.3 Competing bids are discussed at paragraphs 4.34 to 4.39 of the draft Guidelines. When considering such bids, logically “the competitive situation without the merger” involves assessing whether any other bid would be likely to succeed (both commercially, and in obtaining any relevant merger approvals) and, if so, that bid (taking account of any competition remedies) is the counterfactual. The OFT has stated that it will not engage in a comparative analysis of multiple competing bids, whereas the CC's position is that it will, but it is unlikely to treat a referred bidder as the counterfactual because it raises *prima facie* competition concerns and it will not consider a “remedied bidder” as a suitable counterfactual. On this issue, it seems to me that issues of practicability and certainty for the merger parties justify a departure from the strict logic of the counterfactual: it is potentially very complex to investigate which other bidder might succeed and then carry out a competition analysis of that other bidder in order to determine the effect on competition caused by the merger. Moreover, the notifying party (i.e. the potential purchaser) will often not know which bidder would succeed if their bid were ruled out. The OFT's position therefore seems logical and defensible. The CC, however, seeks to refine the analysis reflecting its additional time and resources, but it is not clear why it “breaks the chain of logic” by refusing to consider a remedied bidder as a counterfactual (bearing in mind that the bid could only be cleared on the basis of remedies if those remedies eliminate the SLC that would otherwise arise) and by being unlikely to treat a referred bidder as a counterfactual (even though the “realistic prospect” test for a reference is a low one and many mergers that are referred and go through the CC process are cleared, albeit sometimes with conditions).

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