



**MERGER ASSESSMENT GUIDELINES: A JOINT PUBLICATION OF THE COMPETITION
COMMISSION AND THE OFFICE OF FAIR TRADING**

RESPONSE TO THE CONSULTATION DOCUMENT OF APRIL 2009

1. INTRODUCTION

1.1 Ashurst LLP welcomes the opportunity to comment on the "Merger Assessment Guidelines: Consultation Document, April 2009" ("**the draft Guidelines**") published by the Office of Fair Trading ("**OFT**") and the Competition Commission ("**CC**") - together "**the Authorities**". We regularly advise clients who are parties to mergers, or who are interested third parties or complainants in relation to mergers.

1.2 We welcome the decision of the OFT and CC to produce joint guidelines in relation to merger control and consider that this approach will increase clarity and consistency (the OFT and CC's existing guidelines are quite different in a number of respects). Before making specific comments on the text of the draft guidelines, we would make the following general observations:

(a) there are certain areas where the guidelines are silent or virtually silent. This is particularly notable in relation to the economic assessment of mergers in local markets and in bidding markets. These issues are described further at Section 5 below. We would welcome an extension of the guidelines to deal with these issues, which regularly impact on merger assessment by the OFT and the CC; and

(b) a notable strength of the European Commission's consolidated jurisdictional notice and its horizontal and non-horizontal merger guidelines is that they illustrate general principles with reference to specific cases, both where the point was relevant and where it was not. This approach maximises the usefulness of guidelines to stakeholders, particularly where it demonstrates the application of theory in practice. It also assists parties and their advisers in understanding the key evidence which has driven the analysis in past cases, thereby assisting them in presenting their own case. We therefore welcome the fact that the draft Guidelines do include references to past cases in a number of places but we indicate below where we consider that additional case references would be helpful.

1.3 We also note that, once adopted, the draft Guidelines will replace the existing CC publication "Merger References: Competition Commission Guidelines, CC2" ("**CC2**"). One of the shortcomings of CC2 was that it did not address more than cursorily the CC's procedure in assessing mergers. The draft Guidelines, with their remit of substantive assessment, understandably do not address this shortcoming. In our view, therefore, there remains a need for the CC to produce specific guidelines on its procedure as a Phase II merger control body, given the crucial importance of that role within the UK merger control regime.

1.4 In addition, in respect of those mergers referred to it, given that the CC is the ultimate decision-maker on matters of jurisdiction, we also see a need for CC guidance on jurisdiction. In particular, it would be helpful for the CC to state whether it essentially agrees with the OFT's approach to jurisdiction as set out in its recently published updated guidelines, "Mergers - Jurisdictional and Procedural Guidelines" (June 2009) ("**the OFT Jurisdictional Guidance**"), and to explain how, if at all, its approach might differ from

that of the OFT because of the different burden of proof on it: balance of probabilities as opposed to "realistic prospect".

2. **PART 3: THE RELEVANT MERGER SITUATION**

2.1 We note that the OFT Jurisdictional Guidance looks at the meaning and application of the relevant merger situation concept in considerable detail. We provided a detailed response to the OFT's 2008 consultation on the draft of those guidelines and we would refer the OFT and CC to that response for our views on the meaning and application of the relevant merger situation concept.

2.2 Given the publication of detailed guidance by the OFT, it might be preferable simply to refer readers to that guidance, rather than briefly summarising or repeating parts of it, which inevitably omits much important detail. This approach can also lead to discrepancies between the two documents and associated uncertainty. By way of example, paragraph 3.2.3 on "Associated Persons", refers to the possibility of separate entities being considered to be associated persons where they appear to have common incentives to act together for the purpose of acquiring control. However, the section in the OFT Jurisdictional Guidance on associated persons (paragraphs 3.42 and 3.43) does not refer to such a possibility, but instead states that separate groups of enterprises may be associated persons where they have a common member, something not referred to in the draft Guidelines.

3. **PART 4: A SUBSTANTIAL LESSENING OF COMPETITION**

The counterfactual (paras 4.16-4.44)

The failing firm defence

3.1 We welcome the clarification in the draft guidelines on the differences in approach of the OFT and the CC as regards the counterfactual. However, it would be helpful if the OFT and CC were to expand the current section of the draft guidelines on the failing firm defence. In particular, we would suggest the following additions (existing text is italicised for ease of reference):

(a) a description of the evidence that would assist the OFT and CC in assessing whether a firm is failing. The current OFT merger guidelines state that it may request the following information to give weight to a failing firm defence¹:

(i) *"that the company is indeed about to fail imminently under current ownership (including evidence that trading conditions [and] performance are unlikely to improve);*

(ii) *that all refinancing options have been explored and exhausted;*

(iii) *that there are no other credible bidders in the market, and that all possible options have been explored; and*

(iv) *how the acquiring firm proposes to use the failing firm's assets post merger";*

(b) an explanation of the timescale within which a firm would have to fail in order to meet a failing firm defence; and

(c) additional case references, from both the OFT and the CC, to illustrate how they have applied these various considerations in practice.

¹ See paragraph 4.39.

The failing division defence

- 3.2 The draft guidelines state at paragraph 4.29 that "*Decisions by profitable parent companies to close down loss-making subsidiaries or divisions are unlikely to satisfy the criteria that exit was inevitable, though they may do so in exceptional circumstances*". One potential justification for treating failing division arguments with more caution is provided in the CC's report on *Long Clawson Dairy/Millway*, where the CC states that "[t]he CC applies strict evidentiary standards to arguments regarding failing subsidiaries or divisions of profitable parent companies. One reason for this caution is the opportunity for a group to transfer revenues and costs between group businesses".²
- 3.3 However, assuming that the OFT or CC are able to satisfy themselves that there has been no manipulation of financial data, it is not immediately clear why an unprofitable business which is owned by an otherwise profitable parent company should be treated differently from an independent unprofitable business. If the economics and specific circumstances of the business dictate that it cannot operate on a profitable basis in the medium to long term, there does not appear to be a compelling reason for effectively forcing the parent company to "prop up" the business in the long term. Indeed, in *Home Retail Group/Focus DIY* the OFT observed that "[i]n practice, the OFT has applied the same standard to divisions or stand-alone business units, such as individual stores, as to an entire firm".³
- 3.4 At the very least, it would be helpful if the OFT and CC could clarify the "*exceptional circumstances*" to which the draft guidelines refer. We note that in their seminar of 1 June 2009 the OFT and CC sought to clarify this point by referring to the OFT's decision on *Home Retail Group/Focus DIY*⁴, where a failing division defence was accepted. Evidence referred to by the OFT in that case included the following⁵:
- (a) evidence of poor financial performance of the relevant Focus stores, including particularly the store at St Albans;
 - (b) "*substantially before and unconnected to the merger*", a restructuring company and property agents had been instructed to manage the relevant Focus stores until their disposal or closure;
 - (c) the nominal consideration paid by Home Retail Group for the St Albans store;
 - (d) evidence from relevant third parties that the size and location of the St Albans store made it a particularly unattractive financial proposition; and
 - (e) the process by which the relevant stores had been offered for sale was open to many different kinds of retailers.
- 3.5 Another case in which a failing division argument was accepted was *Long Clawson Dairy/Millway*. Evidence referred to by the CC included the following⁶:
- (a) the Millway business was suffering ongoing financial losses, and Dairy Crest had concluded that it could no longer prop up the business;
 - (b) Millway was experiencing ongoing production quality/consistency problems, which could not be resolved without significant capital investments. Dairy Crest had

² **Long Clawson Dairy Limited and Millway**, CC, 14 January 2009, at paragraph 6.36.

³ **Completed acquisition by Home Retail Group plc of 27 leasehold properties from Focus (DIY) Ltd**, OFT's decision of 15 April 2008, at paragraph 87.

⁴ See Note 3.

⁵ At paragraphs 90-91.

⁶ Op cit, Note 2, at paragraphs 6.26-6.76.

undertaken various capital projects in the past which were aimed at resolving the production problems;

- (c) the business had lost a number of major customers, and appeared to have little prospect of winning them back without resolving its product issues;
- (d) potential purchasers who had been approached had dropped out of the purchase process following detailed due diligence; and
- (e) other possible purchasers who had not been approached were unlikely, in the CC's view, to be interested in purchasing the business once due diligence revealed the extent of the problems being experienced.

3.6 It would be very helpful if additional case references were to be included in the guidelines, which contrasted situations where a failing division defence has been accepted or rejected.

3.7 We would also welcome further explanation as to how the assessment described in paragraph 4.33 as to whether the exit of the failing firm and competition for its market share by the remaining competitors will be a substantially less anti-competitive outcome than the merger being reviewed. This is a crucial aspect of the analysis of a failing firm or division defence which we believe warrants more detailed treatment.

Other points regarding the counterfactual

3.8 We do not agree with the statement in paragraph 4.37 that "*Comparison of two or more problematic mergers against each other would permit all such anti-competitive mergers*". Such an assessment would surely only permit the least anti-competitive of the mergers.

Market definition (paras 4.46-4.83)

Role of supply-side substitutability

3.9 We note that the OFT/CC wish to "downplay" the role of market definition, by instead focusing on the extent to which the merger parties are close competitors, and on competitive constraints, and by viewing market definition as a more "fluid" concept which may change as the analysis progresses. As part of this process, it appears that demand-side substitutability will be the key concept in market definition, with reduced emphasis on supply-side substitutability.

3.10 Whilst we agree that there is sometimes merit in viewing market definition and competitive constraints "in the round", we are concerned that the change of emphasis and reduction in importance of supply-side substitutability may lead to the identification of artificially narrow markets. In particular, a distinction has historically been drawn between supply-side substitutability and new entry on the basis of the time, costs and likelihood of production/supply-switching occurring. Supply-side substitutability has therefore been viewed historically as a stronger and more immediate constraint than new entry. If, as envisaged by the draft guidelines, supply-side substitutability is now given less weight in the analysis of market definition, it would appear that there may be a "blurring" of the concepts of supply-side substitutability and new entry.

3.11 This, in turn, may lead to artificially narrow market definitions based primarily on demand-side substitutability, and bearing little resemblance to the market realities. In turn, artificially narrow market definitions will often lead to artificially high market shares and concentration levels, and these findings will "set the scene" for the analysis of competitive effects. (Some view on market definition will necessarily need to be reached, for market shares and concentration levels to be determined.)

- 3.12 We are concerned that the envisaged change of emphasis may result in a shift in the burden of proof, with an increased evidential burden on merger parties to prove that competitive constraints are strong, such that their artificially high "headline" market shares in a narrowly defined market do not translate into adverse effects on the competitive process. This could subvert the basic legal position that the burden of proof is on the CC to demonstrate that a merger may be expected to result in a substantial lessening of competition. This could also result in increased instances of findings of market dominance in Chapter II cases, on the basis of reliance on artificially narrow market definitions from merger cases as precedents.
- 3.13 This is of particular concern given that, in the context of non-horizontal mergers, the draft guidelines envisage that if the OFT concludes that there is a realistic prospect that the merged firm will have the ability and incentive to engage in foreclosure, it may presume that this will lead to adverse effects⁷.
- 3.14 Furthermore, there have been many cases where defining markets on the basis solely of demand-side substitutability would have led to multiple markets, each of which would have then been subject to a separate analysis of competitive constraints, but where a consideration of supply-side substitutability justifies the definition of just one market.
- 3.15 One case in which a focus on demand-side substitutability would have erroneously led to multiple markets being defined was *Grainfarmers/Centaur Grain* in 2008, where the parties were both active in the purchase and marketing of wheat, barley, oats, different types of pulses, rye/maize and oilseeds. Whilst from a demand-side perspective there was very limited scope to switch between different product types (and then only for some types of end-user), on the supply-side the purchase and marketing of these different products used common facilities. The OFT did not reach a firm view on market definition, but considered that the most appropriate market definition was likely to be the procurement and supply of all grain, pulses and oilseeds⁸.
- 3.16 In *John Thompson/AB Agri (NI)* in 2008, the OFT considered the market for ruminant feeds. Each of the parties supplied a range of different grades of beef cattle, dairy cattle and sheep feeds, and the OFT found that there did not exist demand-side substitutability between feeds for these animals due to their different nutritional requirements. However, from a supply-side perspective, the feeds were "*virtually equivalent*". In this case, the OFT defined one market for all ruminant feeds, facilitating a more straightforward analysis of competitive effects⁹.
- 3.17 Similarly, in *Taminco/Air Products* in 2004, the OFT found that although there was limited demand-side substitution between three different types of methylamines, there was supply-side substitutability between the production of these product categories, which justified the definition of a single market¹⁰.
- 3.18 Particularly in cases involving, for example, chemicals and other industrial products, it is often the case that customers have very specific product requirements, and can purchase only very specific grades or product variants. However, from a manufacturer perspective, supply-side substitutability between different product grades/variants is straightforward.
- 3.19 We note that paragraph 4.51 of the draft guidelines goes some way to acknowledging these points about the importance of supply-side substitutability. However, in doing so,

⁷ At paragraphs 4.145 and 4.150 of the draft guidelines.

⁸ **Anticipated merger between the Grainfarmers Group and Centaur Grain Group**, OFT decision of 30 October 2008, at paragraphs 13-15.

⁹ **Anticipated acquisition by John Thompson Limited of the Northern Ireland Compound Animal Feed business and assets of AB Agri Limited**, OFT, 2 July 2008, at paragraph 16.

¹⁰ **Anticipated acquisition by Taminco NV of the European methylamines and derivatives business of Air Products and Chemicals Inc**, OFT decision of 16 July 2004, at page 2.

the inevitable result is a real lack of clarity about where supply-side substitutability fits into the Authorities' analytical framework. As explained above, in our view, the draft guidelines should be amended to more openly and cogently recognise the important role that supply-side substitutability can play.

- 3.20 Finally, the new approach envisaged by the draft also risks damaging the value of precedents on market definition, because:
- (a) as noted above, in many cases an artificially narrow view on market definition will be reached. This, in turn, will raise prima facie concerns about future merger situations which would otherwise have raised little concern, potentially increasing the burden of proof on, and costs incurred by, the merger parties;
 - (b) in other cases, separate market definitions will be reached for very specific grades or variations of products which would historically have been viewed as part of a wider market. When future merger cases arise which involve similar (supply-side substitutable) products, the precedents on market definition will be of little value.

SSNIP test

- 3.21 Paragraph 4.54 indicates that in applying the SSNIP test, "*some analysis of the characteristics of the product, including its intended use*" may be necessary to establish which possible substitutes might next be included in the product group. It would be useful to expand on this point by outlining other relevant factors, including the physical properties of different products, their relative price levels, and any internal documentation which comments on competition in the marketplace. (A cross-reference to paragraph 4.62 of the draft guidelines may be useful.)
- 3.22 At paragraph 4.55, the draft guidelines indicate that a price increase of 5 per cent will typically be postulated, rather than the usual 5 to 10 per cent. The draft guidelines go on to state that in some markets a different price increase may be used, the guiding principle being that the price increase applied should be one that is judged to be small but significant in the particular market under consideration.
- 3.23 It would be useful if the OFT and CC could provide further information on their rationale for preferring to use a 5 per cent increase in price, and the circumstances in which a 5 per cent price increase is likely to be considered to be inappropriate. In this connection, we note that the OFT's current merger guidelines appear to indicate a more flexible approach, referring to a "*5 to 10 per cent*" price increase¹¹, this being in line with the European Commission's guidance on market definition¹². We also note that the CC has itself sometimes considered 5 to 10 per cent when applying the SSNIP test in merger cases¹³, and that this point was the cause of some debate at the 1 June seminar.
- 3.24 We are concerned that a reliance on a postulated 5 per cent price increase (rather than the usual 5-10 per cent price increase) may lead to situations where markets are defined too narrowly. This is particularly likely where the own price elasticity of demand increases as prices rise (which is a common assumption). Under these conditions, estimates of substitution at prevailing pre-merger prices, in response to a 5 per cent price increase, might well understate the substitution that might occur at higher hypothetical monopoly prices.

¹¹ **Mergers – Substantive Assessment Guidance**, OFT, May 2003, at paragraph 3.17.

¹² See paragraph 17 of the European Commission's **notice on the definition of the relevant market for the purposes of Community competition law**, OJ C372, 9 December 1997.

¹³ See, for example, the **Report on the anticipated acquisition by Pan Fish ASA of Marine Harvest NV**, Competition Commission, December 2006, paragraph 5.35.

- 3.25 We are further concerned that paragraph 4.55 also suggests that it may be appropriate to apply the SSNIP test using a price increase of below 5 per cent. We find it difficult to imagine circumstances where this could be the case and, if this is indeed the Authorities' view, we consider it essential that the rationale and circumstances of application be explained in much more detail, as we would consider this highly unconventional.
- 3.26 The definition of artificially narrow markets will raise issues similar to those discussed above (in relation to supply-side substitutability), potentially resulting in:
- (a) artificially high "headline" market shares for the parties to mergers, higher market concentration levels, and hence greater prima facie competition concerns. (By way of example, this can be a concern in non-horizontal mergers, where the draft guidelines envisage that if the OFT concludes that there is a realistic prospect that the merged firm will have the ability and incentive to engage in foreclosure, it may presume that this will lead to adverse effects¹⁴);
 - (b) an increased evidential burden on merger parties to demonstrate that competitive constraints are sufficiently strong to counteract any potential adverse effects on competition, and a potential *de facto* shifting of the burden of proof (see also paragraph 3.12 above);
 - (c) multiple narrow markets being identified and examined separately, increasing the burden on the parties, regulators and interested third parties;
 - (d) implications for Chapter II cases, where market definition precedents from merger cases are often used; and
 - (e) a reduction in the value of market definition precedents.
- 3.27 At paragraph 4.59 the draft guidelines indicate that following a SSNIP there will be a decline in quantity sold, as customers buy less of the product because of demand-side substitution. However, the key issue is the *aggregate* loss of sales in response to a SSNIP, including not only demand-side substitution to other products, but also due to customers switching to other, non-local suppliers, or simply reducing their overall purchases. It is quite possible that switching to alternative products might on its own be insufficient to render a price increase unprofitable and this also might be the case in relation to geographical substitution, but the combined effect of these factors and general consumer price sensitivity could be collectively sufficient so that price increases would not be profitable. This point should be made explicitly.
- 3.28 More generally, we note that in their seminar of 1 June 2009¹⁵ the OFT and CC explained that in appropriate cases, the hypothetical monopolist test may be applied to parameters of competition other than price, such as R&D, quality or service levels¹⁶. For example, in *Carl Zeiss/Bio-Rad Laboratories*¹⁷, the CC concluded that the application of the SSNIP test would fail to capture the nature of the market(s) for the relevant microscope technologies, which were characterised by strong R&D, rapid technological change, functionality being the main driver of customer choice, and certain elements of a bidding-style market (including a bespoke element to product development). The CC concluded that "*in a context such as the one described it would not be appropriate to limit the market definition exercise to conducting an SSNIP test and we have not attempted to do such a test. Because of the individually configured nature of the products sold and the bidding*

¹⁴ At paragraphs 4.145 and 4.150 of the draft guidelines.

¹⁵ At page 28 of the transcript.

¹⁶ At page 28 of the transcript.

¹⁷ **Carl Zeiss Jena GmbH and Bio-Rad Laboratories Inc**, a report on the proposed acquisition of the microscope business of Bio-Rad Laboratories Inc, CC, May 2004, at paragraphs 4.1-4.6.

features of the sale process a traditional analysis based on price could lead us to define markets that are too narrow". In that case, the CC adopted a "two-pronged" approach to market definition, considering first demand- and supply-side substitutability, and then the nature of R&D competition.

- 3.29 At present, the draft guidelines only touch very briefly on this issue (at paragraph 4.53) and it would be very helpful if the guidelines would elaborate on this point, outlining the types of circumstances where a SSNIP test may not be appropriate, and the OFT's/CC's likely approaches in these circumstances. In particular, case references and practical examples of how the test would be applied in practice using quality/service level changes would be most helpful.
- 3.30 As a final point on the SSNIP test, we consider that paragraph 4.58 concerning the "cellophane fallacy" would benefit from further clarification. In particular, the paragraph does not mention that the fallacy may also come into play where prevailing prices are above the competitive level as a result of unilateral behaviour i.e. the exercise of market power. More importantly, it would be helpful to have some explanation as to the approach the Authorities would take to determine what lower price should be used as a starting point for applying the SSNIP test.

Measures of concentration (paras 4.84-4.93)

- 3.31 Paragraphs 4.84 to 4.87 explain that the OFT and CC may have regard to commonly-used measures of the degree of market concentration in assessing mergers, as these can be indicators of the competitive pressure in a market. However, measures of concentration will have any value only where they are based on a properly defined market, under which supply-side substitutability has been fully taken into account.
- 3.32 We consider that the caveat at paragraph 4.87, that evidence of turbulent market shares may indicate intense dynamic competition, is extremely important. Static concentration measures provide very little information on the dynamics of competition within a market.
- 3.33 In these circumstances, we believe it would be useful if the OFT and CC could provide further guidance on the weight they intend to place on such measures of concentration in their analysis, and we would urge them to exercise caution in placing too much reliance on such measures which cannot fully capture the dynamics of competition or competitive constraints within a market. (This is particularly important given that, as noted above, measures of market concentration will implicitly assume some definition of the market which may, in practice, be too narrow if supply-side substitutability is not given due weight.) It would also be helpful to have further clarity on how the Authorities determine which of the three commonly-used measures of concentration referred to in the guidelines are appropriate in a particular case.

Horizontal mergers – coordinated effects (paras 4.115-4.132)

- 3.34 Whilst we would not advocate a "shopping list" approach to setting out the factors which may influence the risk of co-ordination, there are certain other market factors which could usefully be mentioned in this section. These include:
- (a) product homogeneity/differentiation – it is arguably easier to reach a tacit "agreement" over prices when products are homogeneous;
 - (b) non-price competition – where competition takes place on a variety of bases, even if some form of tacit "agreement" can be reached over prices, it is possible for firms to "cheat" by, for example, improving product quality or customer service, even if prices remain unchanged;
 - (c) multi-market contact – where firms operate together in more than one market, this is generally regarded as being conducive to coordination, as any "cheating" on

tacitly agreed prices in one market can be punished in multiple markets, thereby raising the potential cost of cheating;

- (d) bidding/lumpy markets – where contracts are large and infrequent, and the loss or gain of a particular contract can have a significant impact on a firm's profitability, coordination is less likely. The potential gains to winning a large contract today are significant, relative to the possible losses associated with being punished in relation to another contract at some time in the future.

3.35 Any such list of factors affecting the risk of coordination should carry the caveat that, in practice, some factors will carry more weight than others, depending on the circumstances of the case.

Non-horizontal mergers (paras 4.133-4.173)

Vertical mergers – coordinated effects

3.36 The draft guidelines note at paragraphs 4.169-4.171 that vertical mergers may create or strengthen coordinated effects by, for example:

- (a) allowing the merged firm to gain commercially sensitive information about non-integrated rivals (n.b. this assumes that there is no secret price discounting);
- (b) reducing the number of players in the market (through foreclosure);
- (c) increasing the level of symmetry in a market (where other players are already vertically integrated);
- (d) increasing market transparency (e.g. by giving upstream producers control of downstream prices);
- (e) increasing the punishment mechanisms available to vertically integrated firms which become important suppliers or customers of their rivals;
- (f) increasing barriers to entry into the market (the mechanism here is not explained);
or
- (g) reducing buyer power (if the merger involves the acquisition of an otherwise disruptive customer).

3.37 However, consistent with the OFT's existing guidelines¹⁸, we consider that vertical integration will facilitate collusion only in rare cases and we believe that this should be made clear in the draft guidelines. Moreover, the draft guidelines do not mention that the existence of vertical integration can actually undermine the sustainability of collusion, by hindering market transparency in a number of ways. For example:

- (a) competitors of vertically integrated firms will be able to observe only the final product price and not any internal transfer price (which might be lower than any tacitly "agreed" price for the semi-finished product);
- (b) the vertically integrated firm might not buy any or much of its requirements from competing suppliers. In these circumstances, the vertically integrated firm will gain little knowledge of competitors' prices, and competitors will have little knowledge of the vertically integrated firm's volume requirements; and
- (c) vertical integration might well impede coordination in other ways, such as by permitting various efficiencies to be achieved (thus creating a downward pressure

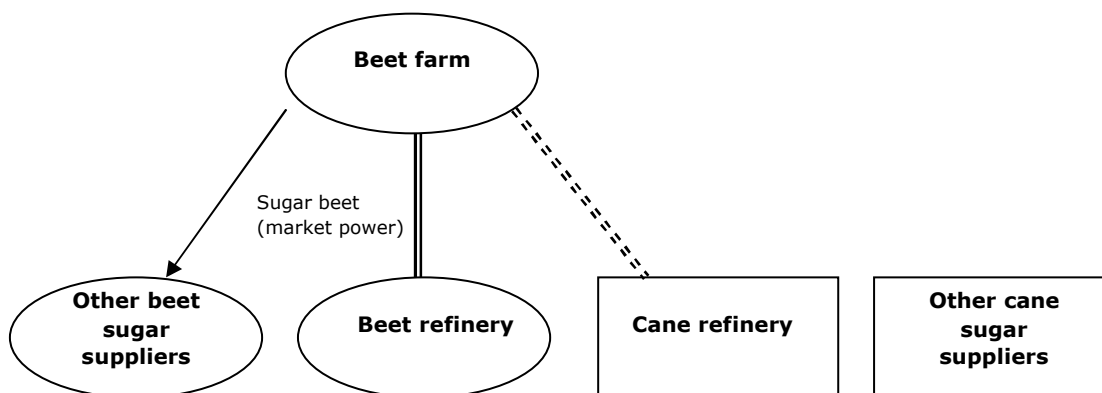
¹⁸ **Mergers – Substantive Assessment Guidance**, OFT, May 2003, at paragraph 5.5.

on prices or improving quality), and/or otherwise leading to greater asymmetries in cost structures.

- 3.38 These points should be set out in the guidelines, in order to provide a more thorough and balanced discussion of the topic.
- 3.39 Paragraphs 4.172-4.173 of the draft guidelines state that, as with vertical mergers, conglomerate mergers may create or strengthen the risk of coordination. The draft guidelines indicate that this may occur by:
- (a) enhancing competitors' ability to agree on a collusive outcome;
 - (b) increasing the scope for punishment;
 - (c) increasing the ability to detect deviations from any collusive "agreement";
 - (d) reducing the incentives of foreclosed rivals to contest a situation of coordination; and
 - (e) increasing multi-market contact.
- 3.40 However, the draft guidelines make no attempt to explain the mechanisms through which the risk of coordination would be increased, presumably in part reflecting the paucity of literature in this area. It is also entirely possible that conglomerate mergers might reduce the risk of coordinated outcomes by, for example, reducing the level of symmetry in a market (e.g. in circumstances where most suppliers in the market are single-product firms), or where firms offer "bundles" of products, thereby reducing the transparency of individual product prices and permitting secret discounting. As is the case with vertical mergers, these points should be set out in the guidelines, in order to provide a more thorough and balanced discussion of the topic.

Diagonal mergers

- 3.41 At paragraph 4.168, the draft guidelines indicate that a diagonal merger may raise competition concerns where the merged company has incentives to increase the price of its own input, and the price of the rival downstream product. The draft guidelines indicate that this could occur where:
- (a) the input is an important component of the vertically integrated firm's output;
 - (b) the firm has market power in the input; and
 - (c) the rival output competes closely with the vertically integrated firm's output.
- 3.42 However, we consider that additional factors would need to be present for a strategy similar to that outlined at paragraph 3.41 above to be profitable. In particular, market conditions must permit the merged firm to raise the price of the rival downstream product, and this in turn requires there to be market power in relation to the supply of this product, and/or scope for coordination in the supply of this product. In the absence of market power in relation to downstream outputs, any attempt by the merged firm to raise downstream prices would serve only to provide profitable opportunities for competing suppliers of the rival downstream product (it should be noted that such suppliers would not be dependent on the merged firm's input).
- 3.43 To repeat the example discussed at the seminar on 1 June, a diagonal merger might involve a sugar beet farm merging with a sugar cane refinery. The sugar beet farm has market power in the supply of sugar beet to sugar beet refineries, and the downstream sugar beet refineries compete with sugar cane refineries in the supply of sugar:



3.44 Accordingly, the three conditions at paragraphs 4.168 of the draft guidelines (and paragraph 3.41 above) are met. However, for the merged firm to be able to raise the price of cane sugar, the merged firm must also enjoy market power in the downstream supply of "all sugar", and/or there must be scope for coordination between suppliers of both types of sugar. Even if the sugar beet farm enjoys market power in the supply of (raw) sugar beet, and thus sugar beet refiners are reliant on the merged firm for their inputs, it does not appear to follow that the merged firm will enjoy downstream market power in the supply of all sugar. (This would be particularly the case if the cane sugar sector were materially larger than the beet sugar sector, and there were a number of significant, independent cane sugar suppliers.)

3.45 Therefore, while some "diagonal" mergers may seem closer in their impact to horizontal mergers, this will depend on the specific facts of the case and, as shown above, a number of conditions will need to be met for there to be a possible adverse effect on competition which we believe should be explicitly recognised in the draft guidelines.

Barriers to entry and expansion (paras 4.174-4.191)

3.46 Paragraph 4.188 of the draft guidelines discusses the factors which determine whether small-scale new entry might be sufficient to act as a competitive constraint. The draft guidelines indicate that small-scale entry may be deemed sufficient to prevent an SLC in a market where goods are undifferentiated and there are no barriers to further expansion. We believe the guidelines should also emphasise that small scale entrants may have a considerable destabilising effect on coordination, because they have every interest in winning market share from their larger rivals, and little interest in the competitive *status quo* in which they receive only a small share of industry profits.

Efficiencies (paras 4.200-4.220)

3.47 As set out at paragraph 4.204, efficiencies must be merger-specific, and judged relative to what would have happened absent the merger. It would be helpful to have further guidance on the extent to which the approaches of the OFT and the CC may differ as regards the assessment of efficiencies, in light of the different approaches they take to assessing the counterfactual (as outlined at paragraphs 4.16-4.4.42 of the draft guidelines).

3.48 Paragraph 4.205 indicates that efficiency claims can be difficult for the competition authorities to identify, and that merger parties need to provide "compelling" evidence to support any efficiency claims. It would be very helpful if the guidelines would elaborate on this point, outlining the types of evidence which would be regarded as compelling. In

this connection, we note that the OFT's existing Substantive Assessment Guidelines expand on the types of evidence required¹⁹:

"Such evidence might, for example, include estimates and origin of likely cost-savings as evidence in pre-merger planning and strategy documents, coupled with objective factual and accounting information needed to verify proposed cost savings claims. External consultancy reports pre-dating the merger might also be helpful in this context."

- 3.49 We note that the OFT found there to be compelling evidence on efficiencies arising through the merger of the London businesses of *Global Radio and GCap Media*²⁰ in 2008. In that case, the OFT described the situation in London as *"a marginal case, where efficiencies were merely required to tip the balance"*. This case highlights an important aspect of the OFT's approach to the assessment of efficiencies – that the extent to which evidence of efficiencies must be "compelling" depends on the gravity of the competition concerns. Paragraphs 143-153 of the OFT's decision set out in some detail the "sliding scale" approach to evidentiary burden advocated by the OFT, and it would be very helpful if the joint guidelines could be expanded on this point. Given that this was the first time that the OFT accepted efficiencies arguments in this way, we wonder whether it would be sensible for the guidelines to highlight more fully the OFT's thinking in that case.
- 3.50 It would also be very helpful if the CC's approach, to the extent that it differs from that of the OFT, were to be set out in the joint guidelines.

4. **PARTS 5 AND 6: PUBLIC INTEREST CASES, INTERIM MEASURES AND REMEDIES**

- 4.1 As noted in our introduction to this response, we believe that there is a need for the CC to produce its own comprehensive guidance on its procedures as a Phase II merger control body. In our view, the majority of the material contained in Parts 5 and 6 of the draft Guidelines would sit much more naturally as part of such guidance (as it focuses more on procedures and legal basis than substantive assessment) and could be given more comprehensive (and therefore helpful) treatment than the current brief summary approach.
- 4.2 Moreover, some of the content concerns the procedure and powers of the OFT and the Secretary of State (specifically paragraphs 5.4 to 5.10 and 6.2 to 6.7), but this is dealt with more comprehensively in the OFT's Jurisdictional Guidance and the brief treatment in these draft Guidelines is not particularly illuminating. It may be preferable simply to refer readers to that guidance.
- 4.3 Similarly, as regards the material on interim measures and final remedies, we note that this material is also more fully covered in "Merger Remedies, Competition Commission Guidelines, CC8" (November 2008) and that the brief treatment here adds little. It may also be preferable simply to refer readers to CC8.

5. **AREAS REQUIRING EXPANSION/FURTHER EXPLANATION IN THE JOINT GUIDELINES**

Mergers in local markets

- 5.1 A significant number of OFT and CC cases have concerned "local" mergers, such as those in the retail and cinema sectors, and these have raised particular issues. These include:

¹⁹ **Mergers – Substantive Assessment Guidance**, OFT, May 2003, at paragraph 4.35. Similar factors are referred to in the EC's **Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings** (2004/C 31/03), at paragraph 88.

²⁰ **Completed acquisition by Global Radio UK Limited of GCap Media plc**, OFT decision of 8 August 2008, at paragraph 16.

- (a) isochrone analysis (to define the scope of local markets, and to identify the competitors active within those markets);
 - (b) fascia counts (as a means of assessing the level of competition and consumer choice available at the local level);
 - (c) diversion ratios (to assess the degree of rivalry between particular players in the market);
 - (d) margin:concentration analyses (to assess the extent to which higher market concentration is associated with higher margins); and
 - (e) illustrative price rise ("IPR") tests.
- 5.2 As the approach to assessing local mergers continues to evolve, the joint guidelines should provide further explanation regarding each of the techniques (and decision rules) currently used by the OFT/CC in such cases. As currently drafted, the joint guidelines discuss some techniques but not others, whilst the wording does not provide any clarification as to how the analysis should be carried out or the decision rules to be applied.
- 5.3 The draft guidelines mention isochrones only very briefly (at paragraph 4.67) and fascia counts (at paragraph 4.101), with very little by way of explanation of how these techniques are to be applied, or how they are used in practice by the OFT and the CC. Further, footnote 70 (which briefly discusses the fascia count decision rule) is extremely vague and provides no degree of certainty to the parties. In this regard, it is not clear why different fascia count thresholds are used in different cases.
- 5.4 In respect of isochrone analysis it would be helpful if the guidelines would provide additional detail on how the OFT/CC undertake such analysis including, for example, how the following issues are dealt with:
- (a) identifying the boundaries of the catchment area around the stores in question;
 - (b) the extent to which competitors located just outside the isochrone are taken into account in the analysis;
 - (c) the extent to which isochrone sizes can be expanded slightly to include "close" competitors;
 - (d) the importance of re-centring isochrones onto competitor stores or population centres, and how such results are interpreted;
 - (e) whether all stores within an isochrone are regarded as "equally close" competitors.
- 5.5 In our experience, these issues, together with technical software issues (e.g. road speed assumptions), can have a significant impact on the identification of potentially problematic areas. As a consequence, isochrone analysis requires some flexibility in interpreting the results, and clearer guidance on these points would be very helpful.
- 5.6 The draft guidelines are silent (except for paragraph 4.101 and footnote 70) on the issue of fascia counts, and it would be very helpful to have further guidance on some aspects of their use by the Authorities. In particular, it would be helpful to have guidance on:
- (a) why the draft guidelines state at paragraph 4.101 that fascia counts are used less by the CC than the OFT: we are not sure that this is in fact the case;
 - (b) how regulators decide how many fascias are necessary in a local area to preserve competition and consumer choice;

- (c) the extent to which there is flexibility in the fascia count analysis; and
- (d) how local market shares and other concentration measures are taken into account in an analysis driven by fascia counts.

5.7 For example, we note that:

- (a) in the OFT's analysis of *Boots/Unichem* (2006), the OFT found a realistic prospect of an SLC in 38 areas with a 2-to-1 fascia count, and a further 61 areas with a 3-to-2 fascia count, each based on a 1 mile radius. Divestments were required in all 3-to-2 areas and 2-to-1 areas, in a mechanistic fashion²¹;
- (b) in the OFT's analysis of *Lloyds Pharmacy/IPCC* (2007), also in the pharmaceutical sector, 3-to-2 areas were regarded as implying a realistic prospect of an SLC, but individual local factors were also taken into account, with divestments being required in only four of the five 3-to-2 areas²²;
- (c) in the OFT's analysis of *William Hill/Stanley* (2005), a 2-to-1 fascia count was used to identify problem areas at a 400 and 800m radius, and a 3-to-2 fascia count was used at a 400m radius²³; and
- (d) in the CC's analysis of *Somerfield/Morrison's* (2005), the CC used a 4-to-3 fascia count to identify potentially problematic areas (and a drive-time of 10 minutes or 15 minutes was used depending on whether the area was rural or urban)²⁴.

5.8 The current draft guidelines discuss diversion ratios at paragraph 4.103, but it would be helpful to have a further explanation of how diversion ratios might be calculated in practice, including through the use of survey evidence, and the limitations of such an approach. Diversion ratios are potentially relevant to other types of merger and not just those involving local markets. However, in practice, diversion ratios have often proved difficult to calculate, either from historical data or from hypothetical survey questions (which possibly explains why they are not referred to in many OFT and CC merger decisions other than in retail mergers).

5.9 At paragraph 4.104, the current draft guidelines also seem to refer to the IPR test (i.e. "*the combination of diversion ratios and gross profit margins can give a strong indication of unilateral effects*"), although the text does not describe it as such. Given that this is a relatively new and theoretical test, which is based on a significant number of assumptions which are not factually relevant in most merger cases, we have strong reservations about the apparently increasing use of this technique, particularly in retail mergers. For example, the IPR test assumes a specific (differentiated Bertrand) model of competition, it assumes that the parties are symmetrical (i.e. they have the same margins, charge the same prices, have the same elasticity and diversion ratios etc.), it is silent about the shape of the demand function, and it says nothing about the decision rule that should be applied (i.e. it estimates that all mergers give rise to an illustrative price rise). Clearly, if the IPR test is to be used by the OFT/CC, then the guidelines need to be much more explicit in explaining how this technique will be applied in practice, and how the results will be interpreted.

²¹ **Anticipated acquisition by Boots plc of Alliance UniChem plc**, OFT's decision of 6 February 2006, at paragraphs 82, 85 and 88.

²² **Anticipated acquisition by Lloyds Pharmacy Limited of Independent Pharmacy Care Centres plc**, OFT's decision of 8 June 2007, at paragraphs 31-34.

²³ **Completed acquisition by William Hill plc of the licensed betting office business of Stanley plc**, OFT's decision of 1 August 2005, at paragraphs 38-39.

²⁴ **Somerfield plc / Wm Morrison Supermarkets plc: A report on the acquisition by Somerfield plc of 115 stores from Wm Morrison Supermarkets plc** (2 September 2005) at paragraph 6.87(c).

- 5.10 Further, if gross profit margins are to be used in the analysis of mergers (as set out in paragraph 4.104 of the guidelines), the guidelines should be much more explicit in setting out how gross margins should in general be calculated (i.e. which costs should be considered to be avoidable and over what time period should the costs be considered to be variable). In this regard, there is no simple and clear-cut way of calculating gross margins (which means that there is potentially a large margin of error to the IPR calculations), which adds to the uncertainty facing merger parties.
- 5.11 We also note that margin:concentration analysis, which has previously been applied by the OFT and CC in a number of cases,²⁵ is not mentioned at all in the draft guidelines. Clearly, if the guidelines are to refer to diversion ratios, gross margins and the IPR test, then they should also refer to the other techniques (including margin:concentration analysis) which have previously been applied by the OFT and CC in assessing mergers.
- 5.12 Merger parties and their advisers would benefit from guidance on these issues, particularly in the light of previous cases where the analysis appears to have been undertaken in different ways. Specific guidance would also be welcome on how isochrone analyses, fascia counts, diversion ratios, the IPR test and margin:concentration analysis are used together by the OFT and the CC, and which of these factors carry the most weight.

Bidding markets

- 5.13 We consider that it would be very helpful if the draft guidelines could be expanded with a section outlining the issues specific to bidding markets, together with appropriate case references.
- 5.14 As illustrated by a number of previous cases, bidding markets, which are characterised by large, infrequent contracts, often raise particular issues as regards market definition, market shares and the assessment of rivalry.
- 5.15 For example, the CC's existing merger guidelines recognise that in bidding markets, which tend not to have multiple buyers and multiple sellers over a continuous time period, competition for contracts occurs only at particular times. The CC's existing guidelines indicate that in these circumstances, the application of the SSNIP test might lead the CC to consider each contract as a market in itself. However, where this would not be helpful in understanding the dimensions of the market within which rivalry between firms occurs, the CC's existing guidelines suggest that it will be necessary to consider other factors relevant to market definition, such as information on the firms bidding for contracts, how they bid, and their track record in bidding for contracts. The CC's existing guidelines state that this type of information may be more informative as to the significance of firms in the market than, for example, their market shares at any specific point in time.²⁶
- 5.16 In this regard, the OFT comments on this issue in its guidelines on the assessment of market power under the Competition Act 1998. It states that:

"Sometimes buyers choose their suppliers through procurement auctions or tenders. In these circumstances, even if there are only a few suppliers, competition might be intense. This is more likely to be the case where tenders are large and infrequent (so that suppliers are more likely to bid), where suppliers are not subject to capacity constraints (so that all suppliers are likely to place competitive bids), and where suppliers are not differentiated (so that for any particular bid, all suppliers are equally placed to win the contract). In these types of markets, an undertaking might have a high market share at a single point in time. However, if competition at the bidding

²⁵ For example, **Somerfield plc / Wm Morrison Supermarkets plc: A report on the acquisition by Somerfield plc of 115 stores from Wm Morrison Supermarkets plc** (2 September 2005).

²⁶ At paragraph 2.29.

stage is effective, this currently high market share would not necessarily reflect market power."²⁷

- 5.17 For example, in its report on *Compass Group/Rail Gourmet Holding/Restorama/Gourmet Nova*, the CC stated that:

*"As the supply of on-train food services to [train operating companies] operates through a series of contracts, which are let at different times by the [train operating companies], it would not matter for the purposes of competition if one company held all the contracts at any point in time, as long as this or other factors did not restrain or prevent the possible entry of a competitor, each time one of those contracts was tendered, or else act to restrain or prevent the regular tendering of contracts."*²⁸

- 5.18 Moreover, in bidding markets, the closeness of competitors may be assessed by the extent to which they have won/lost contracts from one another. For example, in the context of the merger between *Express and Arla* (two processors of fresh liquid milk with similar coverage of England by virtue of their network of depots and dairies), the CC observed that:

*"The parties submitted that although they were clearly competitors, they were not each other's closest competitor. The evidence supports this claim. Since 2000, Express has lost/gained [] supply arrangements for fresh processed milk to the national multiples—Arla UK has lost/gained []. However, only one has involved a national multiple switching supply to a group of stores directly between Arla UK and Express. Rather, it seems to us that, of the four major processors, Wiseman has been the most dynamic in gaining market share. As a result of a lack of investment in new processing infrastructure by both the merger parties (although particularly by Express), they have fallen behind their two main rivals in being able to compete aggressively."*²⁹

- 5.19 The European Commission's horizontal merger guidelines go on to indicate that:

*"In bidding markets it may be possible to measure whether historically the submitted bids by one of the merging parties have been constrained by the presence of the other merging party."*³⁰

- 5.20 In *Express/Arla*, the CC also commented on the risk of coordination in the context of a bidding market:

*".. a coordinated outcome will not be sustainable if there is potential for disruption by new competitors or by customers themselves. In general, coordination is more difficult in bidding markets when individual tenders are large relative to the size of the market, and when transactions take place infrequently. In both instances, this is because it raises the incentive for one of the firms to deviate unilaterally from the coordinated outcome"*³¹

²⁷ **Assessment of market power** (December 2004), at paragraph 4.4.

²⁸ **Compass Group PLC/Rail Gourmet Holding AG, Restorama AG and Gourmet Nova AG**, Cm 5562 (July 2002), at paragraph 2.15.

²⁹ **Arla Foods amba/Express Dairies plc**, Cm 5983 (October 2003), at paragraph 5.120.

³⁰ Cited above, note 19, at paragraph 29.

³¹ Cited above, note 29, at paragraph 5.117. Similarly, in the context of the proposed acquisition of Dräger Medical AG & Co KGaA of certain assets representing the Air-Shields business of Hill-Rom Inc. (Hill-Rom), a subsidiary of Hillenbrand Industries, the CC considered that the bidding nature of the market, a lack of price transparency, and the smaller market shares of rivals rendered coordination unlikely, despite the market being highly concentrated following the merger:

"The incentives to undercut a prevailing level of prices to win a high-value tender would be high and, due

Other areas not dealt with in the draft guidelines

Price discrimination

- 5.21 The only reference to price discrimination in the draft guidelines is found at paragraph 4.56, in the context of a discussion of the SSNIP test. Given that price discrimination can impact on various aspects of merger analysis, we would query whether a short description of the OFT's and the CC's approach to assessing price discrimination would assist merging parties and their advisers. Such a description could cover, for example, the conditions that must hold for a firm to be able to price discriminate (such as having the ability to discriminate between customers, perhaps due to temporal demand, and the inability of customers to undermine price discrimination by engaging in arbitrage).

Acquisition of varying levels of control

- 5.22 Finally, in cases where one firm acquires limited control over another, this may affect the substantive analysis to the extent that competitive incentives are different from those which would exist in a full merger situation. A short description of the OFT's and CC's approach to this issue, together with case references (such as *BSkyB/ITV*³²), would be helpful.

6. OTHER MISCELLANEOUS COMMENTS

Mergers falling under the ECMR

- 6.1 At paragraphs 1.13 and 5.28, in addition to the circumstances already cited, we think it is also worth noting that mergers between licensed water companies which fall under the ECMR may nevertheless be subject to the mandatory reference regime under sections 32 to 35 of the Water Industry Act 1991 and to refer readers to "Water Merger References: Competition Commission Guidelines, CC9".

The SLC test: "theories of harm"

- 6.2 We would welcome clarity on the statement at paragraph 4.8 that both the Authorities (i.e. the CC and the OFT) "*set out the one or more "theories of harm" that they use as the framework for substantive merger analysis*" at the outset of their respective inquiries. Whilst this is something that the CC can and does do, given the work undertaken by the OFT at Phase I, as regards the OFT, our experience is that the OFT certainly does not present the parties with theories of harm at the outset of an inquiry. Indeed, we imagine it would no doubt find it difficult to do so given that its information gathering will not have started. If, as a matter of internal procedure, the OFT sets out at the beginning of a case theories of harm that may be relevant, paragraph 4.8 should make this clear.
- 6.3 In our view the wording of paragraph 4.15 is unfortunate. It can be read as suggesting that the majority of mergers give rise to competition concerns, whereas of course the opposite is the case, as amply evidenced by the fact that only a small proportion of cases reviewed by the OFT are referred to the CC or subject to undertakings in lieu.

to the lack of transparency in the market and the infrequency of purchases, the threat of retaliation low. Moreover, the fact that the merged party would have such a large market share even by comparison with its nearest competitor leads us to believe that the risk of this type of coordination of pricing is not high."
(**Dräger Medical AG & Co KGaA/Hillenbrand Industries, Inc.**, (May 2004), at paragraph 7.13).

³² **Acquisition by British Sky Broadcasting Group plc of 17.9 per cent of the shares in ITV plc: Report sent to Secretary of State (BERR)**, Competition Commission, 14 December 2007.

Market definition for intermediate markets

- 6.4 In paragraph 4.75 we are unclear as to exactly what analysis the Authorities would undertake in relation to the "*determinants of bargaining strength*" and would welcome more explanation as to what is meant here.

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