

UK Merger Assessment Guidelines

LECG comments on the joint Competition Commission and Office of Fair Trading consultation document

August 2009

Introduction

We welcome the opportunity to comment on the Competition Commission (CC) and Office of Fair Trading (OFT) joint Merger Assessment Guidelines. We commend the Authorities for working together to produce a single set of guidelines. The ongoing review of published guidelines is a useful process in itself, as it ensures that the most recent thinking on competition issues is publicly debated, and moves policy in the right direction.

There are many positive developments in these guidelines. In particular, we endorse the Authorities' intention to assess mergers against theories of competitive harm. We also welcome the section on coordinated effects which brings the guidelines up to date with case law.

We have a number of comments on the guidelines which we hope will assist the CC and OFT in subsequent versions of the paper.

General comments

The guidelines inevitably must discuss some complex economic issues. We suggest that it may be helpful to use simple diagrams to explain some of these issues, such as chains of substitution, vertical mergers and diagonal mergers.

The guidelines also provide detailed explanations of issues which do not in practice arise very often, such as conglomerate mergers. We suggest that these issues might be dealt with more briefly.

Counterfactual

Failing divisions

The guidelines state that "*Decisions by profitable parent companies to close down loss-making subsidiaries or divisions are unlikely to satisfy the criteria that exit was inevitable*" (¶4.29). We do not understand why not. The focus should be on whether the subsidiaries would exit the market or not, not on the profitability of the parent company. The

relevance of the Focus/Home Retail merger is also not clear, unless this is provided as an example of an exception to the above statement.

Parallel transactions

One issue we would be interested to receive guidance on is how the Authorities will treat two parallel transactions, which individually would not give rise to an SLC, but together would cause concern. We would be interested to know if one of the transactions would have priority over the other when considering the counterfactual and competitive assessment, and how priority would be determined (e.g. by the announcement date of the transaction or by which is judged to have the less anti-competitive effect).

Market definition

Downplaying market definition

We consider market definition to be a useful tool in determining the competitive constraints on merging parties. We agree that the exercise does not provide the “answer” to a merger inquiry when the market in question is poorly defined. However, the process of market definition is a methodical way of identifying all of the supply-side and demand-side constraints on the merging parties, regardless of whether it enables you to cleanly define a market.

When a market cannot be clearly defined – e.g. because of the so-called “binary fallacy” – there should be caution about reliance on shares of supply or HHIs. However, the process of systematically identifying competitive constraints on the parties’ products should not be bypassed as it informs the analysis of the competitive effects of a merger.

Furthermore, market definition can be highly relevant in certain circumstances. Economic theory indicates that in Cournot markets, the expected price increase arising from merger is directly proportional to the HHI.¹

Market definition is also relevant if thresholds are used in merger assessments. Although the OFT and CC have expressed a desire to avoid using thresholds, several exist within the guidelines: the level and delta of HHIs in ¶4.93; the safe harbour of 40% market share for unilateral effects in footnote 68; the fascia count for retail mergers in footnote 70; the upstream market share of 30% for the ability to foreclose in ¶4.141. The market definition could be critical in determining whether these thresholds are met.

We would propose that the process of defining a market – imperfect as it may be – remains an important component of a competition investigation. However, if the outcome is not sufficiently clear, market shares and HHIs should be treated with some caution (or at least, some sensitivity analysis conducted). That is, if a product only narrowly fails to be included in the relevant market, then its constraining effects should also be considered in the competitive assessment.

¹ This point is also relevant to ¶4.91 of the guidelines which says that “the Authorities rely on [HHIs] only rarely”.

Cellophane fallacy

The cellophane fallacy is an issue that is more usually relevant in dominance cases than mergers. It arises when a dominant firm has raised its price sufficiently far above competitive levels that customers switch to products which would otherwise have been outside the market. In dominance cases competition authorities try to establish what the market would be absent the market power. This is why they may carry out a hypothetical monopolist test on a benchmark competitive price.

In a merger inquiry, the hypothetical monopolist test should be based on the counterfactual price. The guidelines say that when it is thought that the prevailing prices in a market are the outcome of coordination, they may conduct the test using lower prices as a starting point (¶4.58). This implies that if there is coordination in a market, the Authorities consider the correct counterfactual to be the non-coordinated market outcome. If this is the reason for inclusion of a paragraph on the cellophane fallacy in the merger guidelines, it would help if this was clarified.

Elasticities

The guidelines indicate the own-price and cross-price elasticities of demand are taken into account when implementing the hypothetical monopolist test (¶4.61). This section is a little unclear, in particular on how these measures affect the outcome of a SSNIP. It could be stated more explicitly that the own-price elasticity of demand tells us whether a 5% price increase by a hypothetical monopolist will be profitable i.e. whether the market is correctly defined or should be widened. The cross-price elasticity of demand tells us how much substitution there is and where it goes, which informs us on which products should be included if the market definition needs to be expanded.

Switching costs

Switching costs (discussed at ¶4.62 and ¶4.185) might, as noted, affect customers' ability to substitute between alternative products. It is the switching cost relative to the value of the product that is important, not the absolute switching cost.

Supply side substitution

Two important factors to consider with supply side substitution (discussed at ¶4.68 to ¶4.71) are whether (i) the producers will find it privately profitable to divert their production or mobilise their idle capacity and (ii) whether producers will be able to market and distribute the products in a sufficiently timely fashion.

Chains of substitution

The guidelines discuss the merits of "chain of substitution" arguments in ¶4.77. The text is a little unclear as to whether the Authorities consider a chain of substitution test to be an alternative to a hypothetical monopolist test. In our view they are complementary rather than alternative approaches. Chains of substitutes may be a useful starting point in market definition. However, the hypothetical monopolist test is then needed to establish whether the substitutes identified in the chain are sufficiently strong constraints to be included in the relevant product market.

Secondary product markets

Three possible definitions of aftermarkets – system markets, dual markets and multiple markets – are described in ¶4.81. We think that this paragraph could be clarified in two places.

First, it could be made clearer that a system market can occur if high prices in the secondary market are refunded through discounts in the primary market. To have a system market, it must be shown that a price increase in the aftermarket will lead some consumers to switch systems or purchase less of the secondary product. The number of switchers must cause the price increase to be unprofitable for a hypothetical monopolist producing the secondary product only.

Second, at the end of the paragraph, the guidelines state that “[A multiple market] is likely where, having purchased a primary product, customers are (actually or effectively) locked in to using only a restricted number of secondary products that are compatible with the primary product”. However, the situation described can also be consistent with a system market if the conditions described earlier in this paragraph are fulfilled.

Captive production

The guidelines usefully identify the issue of whether captive production should be included in a product market (¶4.82). The context involves transactions between vertically-integrated firms. This issue is also important (often more so) in transactions involving non-integrated firms, when there are rival firms in the same market who are vertically integrated downstream. The question is then whether the vertically-integrated firms would constrain the non-integrated firms by selling into the merchant market.

Furthermore, the relative importance of downstream sales from the vertically-integrated rivals needs to be considered. If the vertically-integrated firms make up a large share of downstream sales, then the downstream customers of the merging parties might lose substantial volumes if their input prices increased. This would limit the profitability of an upstream input price increase by the merging parties.

Unilateral effects

One of the starting points of a competitive effects analysis should be assessing the nature of competition between firms. This 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 (take a three-to-two Cournot merger versus a three-to-two Bertrand merger as an extreme example). We would suggest that the nature of competition, be it on price, quantity, quality, innovation or other strategic variables, should be the first factor to consider.

There is some reference to the different types of competition in ¶4.100 and ¶4.101 (differentiated vs undifferentiated), although as drafted it is not clear how they affect the Authorities’ assessment. Furthermore, ¶4.100 implies that a merger is more likely to be harmful if it is between firms supplying undifferentiated products, where there are few firms in the market and no competitive fringe. This may be true in some situations, in particular when firms compete on quantities or capacity is constrained. However, the factors described could be present in a market where there is almost perfect Bertrand competition, in which case the effects of a merger would be expected to be limited.

We discuss the use of thresholds for various measures of market concentration above. One further point we note is that the usefulness of fascia counts in retail mergers can be improved if assessed alongside outlet counts. If there is a merger between two out of five retail fascias in a particular local area, this could be cleared at Phase 1, even if the merging parties owned 12 out of 15 outlets. An outlet count does not involve substantially more work and can usefully supplement the fascia count where a more detailed market share or diversion ratio analysis is not available.

Coordinated effects

We welcome the guidance on coordinated effects.

One statement that concerns us is in ¶4.120 on evidence of pre-existing coordination. The guidelines state “*market outcomes pre-merger such as pricing and market share may be hard to reconcile with non-coordinated behaviour*”.

This is reminiscent of the CFI Impala Judgement in 2006.² We would be concerned if the quote implies that there is a presumption that stable market shares and prices are indicative of coordination. Price parallelism and similarity (or lack of volatility) of market shares can be consistent with both competitive market and coordinated market outcomes. A lack of evidence to prove the former doesn't prove the latter.

Vertical mergers

The guidelines do not distinguish between the analysis of total and partial foreclosure. However, the economic literature finds that there can be important differences between firms' ability to engage in, and consumer harm from, the two types of foreclosure.

Economic models of total foreclosure find that while it could lead to competitive harm in theory, firms often do not have the ability to commit to such a strategy.³ The theory of harm is that foreclosure occurs if the vertically-integrated firm ceases to supply its downstream competitor – in other words it exits the upstream market. Exiting the market confers enhanced market power on its upstream rival(s), leading to higher upstream prices (in the extreme, from the duopoly to the monopoly price). This upstream price rise increases downstream rivals' costs, foreclosing them from the downstream market.

A potential problem with this theory of harm is that once the vertically-integrated firm has left the upstream market it finds it very difficult to commit to stay out. This is because, once the upstream price has increased, the vertically-integrated firm has an incentive to re-enter the market by slightly undercutting its competitors, making a higher profit than it did previously. Unless the vertically-integrated firm can commit not to re-enter the

² Case T464/04, Independent Music Publishers and Labels Association (Impala) vs Commission, 13 July 2006. The judgement stated at ¶252 that “*close alignment of prices over a long period, especially if they are above a competitive level, together with other factors typical of a collective dominant position, might, in the absence of an alternative reasonable explanation, suffice to demonstrate the existence of a collective dominant position, even where there is no firm direct evidence of strong market transparency, as such transparency may be presumed in such circumstances.*”

³ A comprehensive survey of the literature can be found in the report by Jeffrey Church for the European Commission, “*The Impact of Vertical and Conglomerate Mergers on Competition*”, September 2004

market, its upstream rivals will be reluctant to increase prices, since this would simply trigger re-entry. In this situation no price increase and therefore no foreclosure will occur.

There are ways in which firms can overcome the commitment problem; e.g. by closing down a plant or adjusting their technology so that they are unable to re-enter the upstream market at a later date without incurring some cost.⁴

Economic models of partial foreclosure show that there is rarely consumer harm.⁵ This is because the conditions necessary for partial foreclosure to be profitable (e.g. the input price is a high proportion of the final price, downstream margins are high, the vertically-integrated firm has a high share of the downstream market) are also those which suggest that the double-marginalisation efficiencies will be high.

From a policy perspective, economic theory indicates that there should be less concern about partial foreclosure given that it rarely leads to harm, and that an analysis of total foreclosure should take into account whether firms can commit to a refusal to supply in the long term.

Even total foreclosure may not lead to competitive harm if rival upstream firms can exert counter-strategies. For example, further vertical integration, or efficient (non-linear) contracting, may enable competing firms to generate double marginalisation benefits. It would be helpful if this was noted in the guidelines.

Conglomerate mergers

We have some minor clarifying comments on conglomerate mergers:

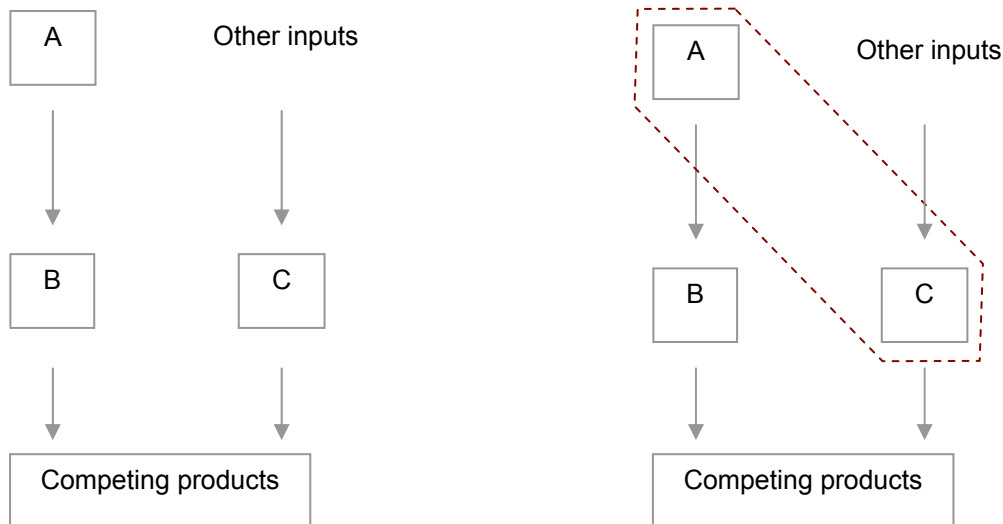
- ¶4.152. Issues with conglomerate mergers involving unrelated products arise only if they are sold to the same customers. As drafted the paragraph links only complementary product sales to the same customers.
- ¶4.155. This paragraph, and footnote 95, is not very clear about the difference between tying and bundling. Pure bundling occurs when products A and B are not sold separately (as described correctly in the footnote but incorrectly in the main text). Mixed bundling occurs when the products are sold both separately and as a bundle, but the bundle is offered at a discount. The difference between tying and bundling, as we understand it, is not an issue of divisibility but an issue of asymmetry. Tying is when customers purchasing product A (the tying good) also have to purchase product B (the tied good). However, they can purchase product B without purchasing product A.
- ¶4.159-4.161. As with the section on vertical mergers, there is no consideration of counterstrategies. Rivals may be able to offer competing bundles; either on their own or together with another producer.

⁴ In Case No COMP/M.4854 TomTom/TeleAtlas (May 2008), the EC Commission considered whether TeleAtlas could commit to not supplying TomTom's competitors by modifying the formats in which it supplied map data (see footnote 159 and ¶201).

⁵ See "*The Impact of Vertical and Conglomerate Mergers on Competition*", Jeffery Church, Report for the European Commission, September 2004, ¶3.2.3 and ¶3.2.6.

Diagonal mergers

Our understanding of a “diagonal” merger is as follows. An upstream firm produces an input A, which it supplies to downstream firms who use it to produce product B. There is a competing downstream product C, which does not use input A. The upstream firm producing A merges with a downstream firm producing C, as illustrated below.



While the upstream firm does not supply the downstream firm it merges with, it may still have an incentive to increase the price of input A. This will increase the price of downstream product B, and drive customers towards product C. There is thus a possibility of foreclosure. Double marginalisation efficiencies do not arise because the upstream firm does not supply the downstream firm it merges with.

The example given in the guidelines in ¶4.168 is slightly different. It involves an upstream firm producing A, who is already vertically integrated into downstream product B, who then merges with a supplier of product C. The main concerns in this type of merger would be the horizontal concerns between the suppliers of B and C. In contrast, in a purely diagonal merger there are no horizontal concerns.

We also note that in a purely diagonal merger, although there is no double marginalisation efficiency, at the same time downstream products are differentiated which reduces the incentive to foreclose.

Entry

An assessment of entry should consider the product lifecycle i.e. whether the market is expanding or contracting (relevant to ¶4.186).

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.

Cost pass through

Cost-pass-through rates are touched upon in both ¶4.6 and ¶4.204.

In ¶4.6 the guidelines state *“an SLC that harms upstream customers will be presumed to lead to detriment to final consumers as well, in the short or longer term.”*

In ¶4.204 they state *“The benefits of efficiencies must be passed on (wholly or partially) to customers of the merged firm. It is sometimes claimed that firms will only have an incentive to pass on efficiencies in a competitive market. The Authorities' view is that this incentive will depend primarily on the demand characteristics facing the merged firm, which will need to be assessed on a case-by-case basis.”*

We have two comments here.

First, we are not sure where the claim that only competitive firms will pass on efficiencies comes from. A firm's cost-pass-through rate depends on the demand and supply elasticities it faces. The cost-pass-through rate can be zero, up to 100% or even higher, even for monopolists, depending on the exact market conditions they face. For example, if the efficiencies reduce marginal costs, then even a monopolist has an incentive to pass on some or all of the benefit to consumers.

Second, if an upstream price increase – or other type of SLC – is presumed to be passed on without further analysis (as per ¶4.6), then it seems inconsistent to have a greater standard of proof for the pass on of efficiencies.



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