

# Merger Assessment Guidelines

## Oxera's response to the joint OFT and CC consultation

July 31st 2009

### Introduction

Oxera is delighted to have been provided with the opportunity to respond to the joint consultation by the Office of Fair Trading (OFT) and Competition Commission (CC) on their proposed Merger Assessment Guidelines, published in April 2009. The Guidelines are an important element in ensuring that the OFT and CC are able to provide a reasonable degree of certainty to both businesses and competition practitioners as to the process that will be adopted and the factors that will be taken into account when assessing merger cases.

Oxera welcomes the joined-up approach adopted by the OFT and CC. The proposed Guidelines remove a number of inconsistencies between the approaches previously adopted by the two authorities.<sup>1</sup> The proposals make the Guidelines more consistent with the approach adopted by the OFT and CC in practice, which, in cases where it is appropriate, goes beyond market definition and market share analysis to assess more directly the effect of the merger on competition.

However, we believe that the ability of the Guidelines to offer effective guidance for both practitioners and businesses could be strengthened in a number of areas, as set out below.

### Market definition

#### Market definition should still play an important role in many cases

While the move towards directly assessing the impact of mergers is an improvement, Oxera's considers that the Guidelines go too far in downplaying the role of market definition. The description of the 'binary fallacy' is correct, but the example used goes further than is

<sup>1</sup> Oxera (2008) 'Response to the Competition Commission consultation on the Merger Guidelines', April 4th. ([http://www.competition-commission.org.uk/about\\_us/our\\_organisation/workstreams/analysis/pdf/response\\_oxera.pdf](http://www.competition-commission.org.uk/about_us/our_organisation/workstreams/analysis/pdf/response_oxera.pdf))

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necessary to illustrate this point, and may be interpreted as suggesting that market definition is largely irrelevant:

unilateral effects arising from a horizontal merger will typically be the same regardless of whether the merger is framed as one generating high concentration within a narrow market, or as one involving the loss of close, direct competition within a broader market. (paragraph 4.47)

In reality, it is unlikely to be the case that a merger of closest competitors in a wider market where each has for example a 5% market share would be as harmful as a merger of closest competitors where each has a 50% market share. A better approach would be to acknowledge that, in many cases, market definition will be an important intermediate step in establishing SLC. There will be cases where a direct assessment of the competitive effects can avoid the need for clearly defined markets, but time and data limitations mean that such cases will remain a minority, particularly at Phase 1.

Furthermore, in various places the Guidelines are based on thresholds which rely on clearly defined markets (and risk ignoring the binary fallacy). These include the 40% market share below which horizontal mergers will not often cause unilateral effects concerns, the 30% upstream market share below which vertical mergers are less likely to lead to input foreclosure concerns, and the various HHI thresholds (footnote 68, paragraph 4.141, and paragraph 4.93 respectively).

### **The increased focus on demand-side substitution needs to be nuanced and carefully explained**

The section on market definition has a heavy focus on demand-side substitution. For example, the Guidelines state that:

products to be included in the relevant market, and the geographic boundaries of that market are generally determined by reference to demand-side substitution alone. (paragraph 4.50)

The focus on demand-side substitution for market definition is reflected elsewhere in the Guidelines. For example, 'the hypothetical monopolist test is used to identify constraints on the ability of the hypothetical monopolist that arise because of demand-side substitution' (footnote 42). Whether supply- or demand-side substitution is important for market definition should depend on the case being considered.

The OFT and CC have since explained that their approach in future will be to define markets based on demand-side substitution, but to include within market share calculations capacity currently outside the market that could be switched to supply the market.<sup>2</sup> While this approach is valid, the Guidelines should explain the approach more clearly, to avoid giving the impression that supply-side substitution is in all cases less important than demand-side substitution.

### **The cellophane fallacy should not be used to address concerns about mergers**

The cellophane fallacy is presented as being relevant to mergers where prevailing prices are not competitive. However, the SLC test is concerned with a substantially lessening of competition, not with the level of pre-existing competition per se. Oxera recognises that the authorities must prevent the merger regime being used as a way for firms in coordinated industries to make their coordinated behaviour permanent. However, the cellophane fallacy is not the appropriate tool for this, and its inclusion in the Guidelines creates confusion over the relevance of the cellophane fallacy to merger analysis in general.

<sup>2</sup> Meeting between OFT and CC officials and Oxera, July 20th 2009.

## Thresholds

The 25% market share threshold contained in the previous CC guidelines, below which horizontal mergers were deemed less likely to be of concern, has been replaced with new wording which states that ‘market shares of less than 40 per cent will not often give the OFT cause for concern over market power leading to unilateral effects’ (footnote 68). It is not clear how this will affect cases in sectors where the 25% threshold was previously used either directly or indirectly, such as funeral services (eg, *CGL/Burgess & Son*) and supermarkets (eg, *CGL/Somerfield*). This may lead to some uncertainty among firms and practitioners involved in these types of cases. It would be helpful if the authorities were able to provide guidance on how such cases will be approached in future.

No guidance is provided on what makes a lessening of competition ‘substantial’. This matters in the context of merger simulation, where the models predict a price rise. The question is then whether that price rise is significant. A 5% threshold has been used in past cases, such as those in the grocery sector, but the Guidelines do not match this practice (paragraphs 4.3 and 4.15).

The Guidelines refer to a 5% SSNIP threshold, which reflects the CC’s previous guidelines—the previous OFT guidelines used 5–10%. There is a risk that this change gives spurious importance to a single number, whereas providing a range shows that there is not a right number as such. Although the authorities have argued that the 5% threshold is nuanced by subsequent text in the Guidelines, it is nonetheless the case that practitioners carrying out empirical tests are, in practice, likely to make use of the threshold numbers available in the Guidelines, however carefully they are nuanced by the supporting text.

## The failing-firm defence

The discussion of the failing-firm defence sits slightly uneasily in the section on the counterfactual. Many of the issues in the failing-firm defence are indeed related to the counterfactual, but others go beyond simply what would have happened ‘but for’ the merger. For example, it is noted that profitable parent companies closing down loss-making subsidiaries are unlikely to meet the criteria, although they may do so in exceptional circumstances. It may be the case that, in the most likely counterfactual, the subsidiary would have been closed down. Although the counterfactual approach was adopted in *Homebase/Focus*, it is not clear why such defences can be accepted only in exceptional circumstances (paragraph 4.29). It is also noted in the Guidelines that there must be no serious prospect of reorganising the business (paragraph 4.29). Again this appears to go beyond simply assessing competition under the most likely counterfactual.

We suggest that either the failing-firm defence is worthy of section in its own right, or the wording of the criteria should be changed to reflect that the failing-firm defence does not go beyond what would have been expected to occur in the counterfactual.

## Coordinated effects in horizontal mergers

It is important to emphasise in the Guidelines that firm conclusions on the drivers of coordinated effects from economic theory and evidence are still limited. The Guidelines should also emphasise that each of the characteristics associated with coordination is necessary but not sufficient to foster coordination (in the current draft of the Guidelines, this is mentioned only very briefly). The issue of symmetry of market shares is a case in point.

While in some cases, without symmetry, coordination may be more difficult,<sup>3</sup> even in markets with perfectly symmetrical market shares, this will not assist coordination if firms have very different incentives, cost structures or underlying technologies.

A specific issue of concern is the ability to achieve and monitor the terms of coordination. The Guidelines state that a firm might be able to monitor deviations from the coordinated outcome by simply observing its own volume and capacities. Since every firm can be expected to know its own volumes and capacity, a literal reading of this section is tantamount to eliminating this criterion from the analysis.

## **Non-horizontal mergers**

There is a useful discussion of the Cournot effect in the section on conglomerate mergers (footnote 103). However, this issue of mergers between complementary products applies equally to vertical mergers. It would make sense for there to be a general discussion at the start of the section on non-horizontal mergers on the benefits of merging complementary products. This general discussion could then be referenced in each of the relevant sub-sections.

## **Conclusion**

Oxera hopes that these comments are helpful to the OFT and CC, and would be happy to discuss them in more detail.

<sup>3</sup> Although, as the Guidelines also note, some models suggest that coordination can be assisted by the presence of a market leader.