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Agenda

Advancing economics in business

2-to-1 mergers: impossible to clear?

A number of (seemingly) 2-to-1 mergers, as well as other mergers in concentrated markets, have been allowed by competition authorities in recent years. Given that the aim of these authorities is to promote effective competition—which is generally found in markets with many companies—how were these mergers allowed? This article presents a number of justifications, which have been, or could be, used in such mergers

Most jurisdictions have rules that prohibit mergers that cause competitive concerns, generally assessed in the form of high market concentration. As a result, some 2-to-1 mergers would probably not even be attempted—eg, mergers between Coca-Cola and Pepsi, or between McDonald's and Burger King—since it seems unlikely, prima facie, that they would be allowed. However, not all 2-to-1 mergers are prohibited. In fact, a number of (what appear to be) 2-to-1 mergers have been allowed by various competition authorities in the past few years.

Starting with the most recent case, on April 15th the UK Office of Fair Trading (OFT) cleared the acquisition of Amazon Inc.'s online DVD rental business by LOVEFiLM International.[1] Following the merger, LOVEFiLM will account for over 90% of online DVD rental services in the UK.

On March 24th, the US Department of Justice (DoJ) announced that it would allow XM Satellite Radio Holdings Inc. (XM) to merge with Sirius Satellite Radio Inc. (Sirius), thereby creating a monopoly provider of satellite radio services in the USA.[2] The merger must now be approved by the Federal Communications Commission before it can be finalised.

In 2007 the Netherlands Competition Authority (NMa) approved a merger between the only two large Dutch sugar producers (Cosun and CSM), thus creating a company with virtually 100% of the production capacity in the Netherlands,[3] and it also approved a merger between the only two major flower auction houses.[4]

In addition, several other mergers in concentrated markets—ie, mergers where the merging parties had significant market shares prior to the merger, but were not quite 2-to-1—have also been allowed by competition authorities. For example, in April 2006 the UK Competition Commission cleared the acquisition of Macaw Holdings Limited (Macaw) by Cott Beverages Limited (Cott), which were the two largest producers of own-label carbonated soft drinks (CSDs) in the UK before the merger.[5] Post-merger, the company was expected to have a market share of around 50% based on production capacity, or 65% based on sales by volume.

How were these mergers allowed? A number of justifications are presented below.

How to successfully clear a 2-to-1 merger

Considering a 2-to-1 merger? If recent mergers are anything to go by, the following factors will enhance the chances of success:

- **substitutes are available, and customers switch;**
- **price elasticity of demand is high;**
- **there are low barriers to entry (and the merging parties operate in a bidding market);**
- **the consumers have buyer power.**

Substitute products

Arguably, the most important justification of a 2-to-1 merger is that there are substitute products available, and consumers consider them to be such.[6] As a result, it is likely that the product market will be wide, and therefore that the merger would not in fact be 2-to-1. This was the case in XM/Sirius, and may have been the case in LOVEFiLM/Amazon although the OFT did not reach any firm conclusions on market definition.

In LOVEFiLM/Amazon, the OFT cited some evidence which pointed to a market wider than online DVD rentals, while other evidence pointed to the product market being online DVD rentals only. In the end, the OFT did not make a final decision on the product market, stating that:

> Given the unusually strong evidence of constraints from suppliers not utilising the [online DVD rental] business model to supply video content to consumers, and the unusually close relationship between market definition and the

> effects analysis in this case, it serves little purpose here to draw hard and fast conclusions on product market definition to frame the competitive assessment.[7]

However, more crucially, the OFT found that there are substitutes to online DVD rental, and that these products may in fact be closer substitutes to LOVEFiLM's online DVD rental than Amazon's online DVD rental business. Therefore, following the merger, LOVEFiLM would face similar constraints on its prices as it did before the merger, and thus price increases are unlikely to be profitable.

In XM/Sirius, the product market was defined as being broader than satellite radio services. Therefore, even though XM and Sirius would become a monopoly provider of satellite radio services, they would continue to be constrained by providers of AM/FM radio and HD radio services, as well as other sources of entertainment.

A growing number of substitutes seem to be particularly relevant in the technology sectors, which tend to be younger markets, and are thus evolving at a fast rate. As a result, could (seemingly) 2-to-1 mergers have a higher chance of being cleared in such markets? The evidence seems to suggest so, as in addition to the LOVEFiLM/Amazon and XM/Sirius mergers, there have been several others in the last few years. For example, in December 2006 the NMa allowed a 3-to-2 merger between cable-TV companies Essent Kabelcom and Casema Multikabel in the Netherlands.[8] Similarly, a year earlier, the OFT allowed the two remaining UK cable companies (NTL and Telewest) to merge.[9] The main reason for clearing the merger was that the product market was wider than cable-TV.

Related to this point is the expectation for the price elasticity of demand to be high.[10] When this is the case, following a price increase, customers will either:

- switch to alternative products (captured above); or
- stop consuming the product altogether.

The second point may mean that even relatively small price increases (eg, 5–10%) may not be profitable following a (2-to-1) merger because too many customers would stop purchasing the product. Thus, although the merged company may have a significant market share following the merger, it need not have (any) market power, or an ability to raise prices.

Low barriers to entry and bidding markets

Another justification of a 2-to-1 merger could be low barriers to entry, which would make entry into the market easier for rivals, particularly through low costs associated with doing so. This could affect prices in the market in two ways: through actual entry, and/or through the threat of entry.

First, where there are low barriers to entry in a market, any price increases in that market above the competitive level should lead to new companies entering the market—ie, actual entry. Following entry, there will be increased competition in the market as the new entrants fight for a share of the incumbents' customers. This should lead to prices falling to competitive levels, which, in theory, is the long-term equilibrium in markets with low barriers to entry.

Second, the mere threat of entry may act as a constraint on prices in the market. Because incumbents know that if they increase prices, new companies will enter the market and drive prices down, they may be forced to set prices at competitive levels in order to prevent new companies actually entering.

As a result, high market shares in markets with low barriers to entry may not be indicative of dominance. This was recognised by the European Commission in its Article 82 discussion paper:

> if the barriers to expansion faced by rivals and to entry faced by potential rivals are low, the fact that one undertaking has a high market share may not be indicative of dominance.[11]

The low barriers to entry justification was used in the Cosun/CSM 2-to-1 merger in the Netherlands, where, because of a new EU Regulation in 2006, the barriers to the importing and exporting of sugar were significantly lowered. Thus, the NMa considered that it was likely that sugar producers from neighbouring EU countries would enter the Dutch market and, as a result, the merger would not lead to a lessening of competition.

In addition, competition authorities in Europe will consider barriers to entry in many mergers. For example, in the recent Cott/Macaw merger, the Competition Commission investigated barriers to entry into the own-label CSD market. In this case the Commission rejected the likelihood of entry into the own-label market even though entering own-label CSD production could take place relatively quickly and at a low cost. However, the merger was still cleared through the buyer power justification discussed below.

Given the difficulty of assessing barriers to entry with certainty, competition authorities will tend to take a cautious approach. Therefore, where possible, the low barriers to entry justification should be used in conjunction with other justifications in order to increase the chances of a successful merger.[12]

The low barriers to entry argument is particularly relevant in bidding markets.[13] In a bidding market, competition is *for* the market rather than *in* the market, and therefore large market shares do not necessarily imply market power. As a result, two to three competitors can be sufficient to keep prices at desirable levels.[14]

Low barriers to entry in a bidding market context was an argument put forward in the merger between two of the largest bus operators in the Netherlands, Connexxion and GVU, in 2006.[15] The bus companies were bidding against each other in order to run franchises. The merging firms were facing two other large potential bidders, while one of the merging parties was found to have been a relatively weak bidder in several previous bidding processes. As a result, the NMa considered that the merger would not result in a lessening of competition.

Buyer power

Buyer power can be a strong justification for a 2-to-1 merger. It occurs where the merging parties face customers that are large and have (significant) market power. As a result, the buyers are able to influence the price at which they purchase the product, while the suppliers have limited, or no, market power.

For this argument to be successful in a 2-to-1 merger, the market characteristics would need to be such that, even following the merger, the now only supplier would have limited, or no, market power.

The recent Cott/Macaw merger was allowed on the grounds of the buyer power argument. In particular, buyer power enjoyed by the larger supermarkets that purchased the own-label soft drinks was expected to continue constraining the prices of Cott and Macaw after the merger was completed. As a result, the merger was not expected to result in a significant lessening of competition in the own-label CSD market, despite the resulting high market share.

The buyer power argument was also used in the flower auction houses merger in the Netherlands (among other arguments), where large buyers made up a significant proportion of the customers of the two merging auction houses. These customers were considered to have the option of purchasing flowers directly from the growers, thus completely bypassing the auction houses. As a result, the auction houses were considered to be constrained in their ability to increase prices.

Conclusion

As this article has shown, it is not impossible to have a 2-to-1 merger cleared. In most cases approval requires showing that the merging parties operate in a wider market, and thus that the merger is not actually 2-to-1. In other cases economic features such as bidding markets, or low barriers to entry, can be considered as offsetting any concerns over high concentration.

In all, strong evidence would be needed to show that a (seemingly) 2-to-1 merger would not result in increased prices for consumers (and more generally a significant lessening of competition). However, recent examples—such as the LOVEFiLM/Amazon and XM/Sirius merger rulings—show that competition authorities are open to considering such arguments, and therefore that 2-to-1 mergers may not be impossible to clear after all.

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[1] OFT (2008), ‘OFT Clears LOVEFiLM’s Acquisition of Amazon’s Online DVD Rental Business’, press release April 15th, and OFT (2008), ‘Anticipated Acquisition of the Online DVD Rental Subscription Business of Amazon Inc. by LOVEFiLM International Limited’, May 8th. Oxera advised the merging parties during the OFT inquiry.
[2] Department of Justice (2008), ‘Statement of the Department of Justice Antitrust Division on its Decision to Close its Investigation of XM Satellite Radio Holdings Inc.’s Merger with Sirius Satellite Radio Inc.’, press release, March 24th.
[3] Zaak 5703/*Cosun – CSM*, April 20th 2007.
[4] Zaak 5901/*Bloemenveiling Alsmeer – FloraHolland*, August 21st 2007.
[5] Competition Commission (2006), ‘Cott Beverages Ltd and Macaw (Holdings) Ltd Merger Inquiry’, March.
[6] Both elements need to be satisfied; first there need to be alternatives available to consumers in the event of a price increase (or a reduction in quality). Second, consumers must consider these alternatives to be close substitutes and should be switching between them.
[7] OFT (2008), ‘Anticipated Acquisition of the Online DVD Rental Subscription Business of Amazon Inc. by LOVEFiLM International Limited’, May 8th.
[8] Zaak 5796/*Cinven – Warburg Pincus – Essent Kabelcom*, December 8th 2006.
[9] OFT (2005), ‘Anticipated Merger of NTL Incorporated and Telewest Global Inc: The OFT's Decision on Reference under Section 33(1) Given on 30 December 2005’. Oxera advised the merging parties in both the Dutch and UK cable mergers.
[10] The price elasticity of demand captures the responsiveness of demand to changes in price. So, for example, if demand falls by a significant amount (eg, 20%) following a small price increase (eg, 5%), the price elasticity of demand is said to be high.
[11] European Commission (2005), ‘DG Competition Discussion Paper on the Application of Article 82 of the Treaty to Exclusionary Abuses’, consultation paper (IP/05/1626), December 19th, p. 12, para 34.
[12] For further detail on the assessment of barriers to entry, see *Agenda* (2006), ‘Deconstructing Entry Barriers: Crystal Ball Gazing or Hard Economics?’, August. Available at www.oxera.com.
[13] It is worth noting that the bidding markets justification can be used in mergers in concentrated markets, but not in 2-to-1 mergers specifically, where it is unlikely to be successful.
[14] For further details on the bidding market defence in mergers, see *Agenda* (2006), ‘Bidding Farewell? The “Bidding Market” Defence in Competition Investigations’, March. Available at www.oxera.com.
[15] Zaak 5840/*Connexion—GVU*, December 19th 2006.

If you have any questions regarding the issues raised in this article, please contact the editor, Derek Holt: tel +44 (0) 1865 253 000 or email d_holt@oxera.com

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