Oxera

Agenda

Advancing economics in business

Merging the merger guidelines

The proposed Competition Commission and Office of Fair Trading joint merger guidelines bring together for the first time the approaches to merger assessment of the two UK competition authorities, removing some previous inconsistencies. The most controversial change to the substance of the guidelines is the proposal to reduce the emphasis on market definition in favour of a more direct analysis of competitive effects. Is this the correct approach to adopt? What are the strengths and weakness of the other proposed changes?

The Competition Commission (CC) and Office of Fair Trading (OFT) consultation on their proposed joint merger assessment guidelines came to a conclusion in August 2009. The joint guidelines aim to bring together and build on several of the CC's and the OFT's existing merger guidance documents.[1] The consultation involved unprecedented face-to-face discussions with external lawyers, economists and other interested parties. The guidelines also take into account comments from CC members and OFT board members, as well as other government departments and the European Commission.

Since the publication of the first guidelines in 2003, a number of developments have taken place in the merger process. For example, the decision-making practices of both the CC and the OFT have moved way from simplistic market definition and market share analysis to focus more on examining the effects of mergers on competition. In addition, the failing-firm defence is currently more prominent as a result of the financial crisis. These developments have helped to shape the new guidelines. This article sets out the context in which the guidelines were published and discusses the key differences of these recent proposals in comparison with previous guidelines. It draws on comments that Oxera has provided to the CC and the OFT, during the course of both face-to-face discussions with officials and through written comments.

Context

These new guidelines represent the first joint guidance document produced by the CC and the OFT, and supersede the merger guidelines previously produced by each of the two UK competition authorities. The document sets out the approach adopted by the OFT in assessing whether to refer a merger to the CC. It also outlines the approach adopted by the CC in examining any merger referred to it.

The guidelines outline the UK merger regime and set out the overarching questions that the CC and the OFT will consider in conducting reviews of mergers. They also define what constitutes a 'relevant merger situation' or 'substantial lessening of competition' (SLC), and outline the concepts underlying 'theories of harm' and the 'counterfactual', as well as discussing the criteria and methodology to be adopted by the CC and the OFT in considering the SLC test.

Several changes stand out, the most significant being a reduced emphasis on market definition and market shares, while greater importance is attached to effects-based evidence—an approach consistent with that recently adopted by the OFT in cases such as *Homebase/Focus*.[2] Furthermore, the guidelines no longer refer to the 25% market share threshold which previously defined the level below which a horizontal merger would be less likely to raise competition concerns.

At a high level, the joined-up approach adopted by the CC and the OFT is a welcome development. The proposed guidelines remove a number of inconsistencies between the approaches previously adopted by the two authorities, including the use of different thresholds for measures of market concentration. The CC/OFT joint proposals also make the guidelines more consistent with the approaches adopted by these two organisations in practice, which, where appropriate, go beyond market definition and market share analysis to assess more directly the effect of any potential merger on competition. Nonetheless, the ability of the guidelines to offer effective guidance to both practitioners and businesses could be strengthened in a number of areas.

Market definition

One respect in which the guidelines have changed significantly concerns their reduced emphasis on market definition. Under the proposed guidelines, emphasis now rests more directly on the assessment of the impact of any merger on competition, irrespective of the precise market definition. This type of analysis has been used in a number of recent merger cases, such as *Co-operative Group Limited/Somerfield*, cleared by the OFT in 2008, in which customer survey data was combined with information on store-level gross margins to assess directly the likely impact of the merger in the local areas affected.

The move towards the direct assessment of the impact of a potential merger is an improvement over those assessments previously conducted solely on the basis of market shares. However, the guidelines will be seen by many as going too far in downplaying the role of market definition. For example, the guidelines describe the 'binary fallacy', whereby an overemphasis on market definition can lead to the incorrect assumption that competitor products outside the relevant market exert no constraint on those within the market. However, the example used by the authorities to illustrate this point goes further than is necessary, and risks giving the impression 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 (para 4.47)

A better approach might be to acknowledge that, in many cases, market definition will continue to be an important intermediate step in establishing SLC. There will of course be some cases in which a direct assessment of the competitive effects can reduce the need for clearly defined markets, but time and data limitations mean that such cases will remain a minority, particularly during Phase 1 of any investigation.

Furthermore, in various instances the guidelines are based on thresholds which rely on clearly defined markets, and which risk ignoring the very binary fallacy about which the guidelines warn practitioners. These include the 40% market share below which horizontal mergers will often not give rise to unilateral effects concerns; the 30% upstream (wholesale level) market share below which vertical mergers are less likely to lead to input foreclosure concerns; and the various market concentration thresholds. (See footnote 68, para 4.141 and para 4.93.)

Increased focus on demand-side substitution

Substitution between products or services is central to the definition of markets in merger investigations. In Europe, competition authorities generally take into account both demand-side substitution—that is, the switching by customers away from the products in question)—and supply-side substitution—that is, the switching by rival firms into supplying the products in question. In contrast, in the USA, market definition analysis tends to ignore supply-side substitution, instead dealing with it as part of the subsequent analysis of competitive effects.

The new joint guidelines' stipulations on market definition have a heavy focus on demand-side substitution, stating, for example, 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—ie, the extent which customers can readily switch to substitute products and geographic areas, depending on the alternative sources of supply currently available in the market. However, the likely reactions of firms not currently supplying goods in the relevant market to a change in competitive conditions (ie, a supply-side reaction) also has to be assessed (para 4.50)

This focus on demand-side substitution in market definition is reflected elsewhere in the guidelines. The CC and the OFT have since explained that their general approach in future will be to define markets on the basis of demand-side substitution, but to include, within this, market share calculations—ie, the capacity currently outside the market that could be switched to supply the market. This change in emphasis—reflecting, to a greater extent, a US-style approach to market definition—is not necessarily problematic as long as supply-side substitution is given appropriate weight in any competitive effects analysis. However, the guidelines need to explain the approach clearly, and avoid giving practitioners the impression that supply-side substitution is, in general, less important than demand-side substitution—whereas, in fact, the relative importance of these two factors depends on the products being analysed.

The 'cellophane fallacy'

The cellophane fallacy describes the problem of defining markets in which the supplier of the product in question has existing market power. In general terms, a supplier with market power can be expected to raise prices above competitive levels. When the market definition test—ie, of raising prices by a small but

significant amount (the SSNIP test)—is applied to these already increased prices, markets can be defined too broadly.[3] The cellophane fallacy is particularly relevant to abuse of dominance cases where the competition issue ultimately concerns prices being raised above competitive levels, and where the firms under investigation may well have the ability to raise prices unilaterally.

In the new proposed guidelines, the cellophane fallacy is presented as also being relevant to mergers in which pre-merger prices are not competitive, in particular those in which the prevailing prices might be the outcome of coordinated behaviour between firms. However, in mergers, the SLC test is concerned with an SLC as a result of the transaction, not with the level of pre-existing competition per se. Clearly, the authorities wish to prevent the merger regime from being used as a way for firms in coordinated industries to make their coordinated behaviour permanent by merging with each other. However, using the cellophane fallacy in this way is misguided; its inclusion in the guidelines may give rise to a misconception regarding its relevance to merger analysis in general.

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 in which the 25% threshold was previously used either directly or indirectly, such as funeral services (eg, *Co-operative Group Limited/George Burgess & Son*, cleared by the OFT in 2009) and supermarkets (eg, *Co-operative Group Limited/ Somerfield*). This may lead to some uncertainty in the future among firms and practitioners involved in these types of case.

The guidelines do not provide a threshold stipulating where an SLC is likely to be considered 'substantial'. This is important in the context of merger simulation analysis, where the economic models are designed to predict a post-merger price rise. The question is then whether that price rise is significant. An informal 5% threshold has been used in previous cases, such as those in the grocery sector, but the guidelines do not match this practice (see paras 4.3 and 4.5).

In the section on market definition, the guidelines refer to a 5% SSNIP threshold—that is, whether it is likely that sufficient customers would switch away from the product (or products) in question if the price of such product(s) were increased by 5%. This level reflects the CC's previous guidelines, whereas the previous OFT guidelines used a level of 5–10%. There is a risk that this change gives spurious importance to a single number, whereas the stipulation of a range would demonstrate that there is, as such, no single correct number for the conduct of these tests. Although the authorities have since argued that the 5% threshold is nuanced by the 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. Providing a suitable range rather than a single number would reduce this problem.

The failing-firm defence

As mentioned above, the current financial crisis and the subsequent increase in firms entering into administration and liquidation have, in a number of cases, brought the issue of the failing-firm defence to the fore.[4] Under the proposed new guidelines, in contrast to previous guidelines, the discussion of the failing-firm defence is contained within the section on the counterfactual—ie, the analysis of the competitive outcome in the absence of the merger.

The discussion of the failing-firm defence sits slightly uneasily in the context of the counterfactual. Many of the issues contained 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, the guidelines note that profitable parent companies closing down loss-making subsidiaries are unlikely to meet the criteria, although they may do so in exceptional circumstances (para 4.29). Although the counterfactual approach was adopted in *Homebase/Focus*, it is not clear why such defences can be accepted only in exceptional circumstances. The guidelines also note that there must be no serious prospect of reorganising the business in question. Again, this appears to go beyond a simple assessment of competition under the most likely counterfactual. To rectify this problem, the failing-firm defence might be better addressed in its own right within a separate section of the guidelines, thus demonstrating that the required analysis and evidence go beyond a simple analysis of the counterfactual.

Non-horizontal mergers

The guidelines include a useful discussion of the Cournot effect (footnote 103), which occurs when complementary products are brought under common control—for example, through a merger.

Complementary products (for example, gin and tonic) have the characteristic that where the price of one decreases, demand for the other increases—ie, if the

price of gin goes down, people buy more gin, and consequently more tonic to mix with it. A merger between producers of complementary products might lead to lower prices because any subsequent lowering of the price of one product might benefit the merged entity by generating increased demand for both products.

However, the discussion is currently confined to that part of the new guidelines that addresses mergers between vertically integrated and/or other multiple producers. The issue of mergers between producers of complementary products also applies to vertical mergers, as products at different levels within the supply chain (such as inputs and final products) are complements for each other. The guidelines could be improved by the inclusion of a general discussion on the Cournot effect in the context of a discussion on non-horizontal mergers.

Conclusion

The proposed joint merger guidelines will be an important reference source for businesses, competition lawyers, and economists. Therefore, the guidelines need to be clearly presented and based on sound economic analysis. At a high level, the guidelines present a welcome improvement on earlier versions, and reflect changes to the CC's and the OFT's analysis of cases in practice. However, there are a number of key areas in which the guidelines could be further improved, including, for example, some aspects of the approach to market definition, the failing-firm defence, and the use of thresholds.

Taking into account these improvements, the final version of the guidelines, due to be published in late 2009, should prove to be a valuable resource for all those working in UK mergers.

---

[1] Competition Commission (2003), 'Merger References: Competition Commission Guidelines', CC2, April; Office of Fair Trading (2003), 'Mergers: Substantive Assessment Guidance', OFT 516, May; Office of Fair Trading (2004), 'Guidance Note Revising Mergers: Substantive Assessment Guidance', OFT 516a, October; Office of Fair Trading (2007), 'Revision to *Mergers—Substantive Assessment Guidance*: Exception to the Duty to Refer: Markets of Insufficient Importance', OFT 516b, November.
[2] In this regard, the guidelines state that: 'Since the process of market definition can be time consuming and resource intensive, the Authorities may not conclude on a market definition and may instead consider several alternative market definitions as part of the investigation. For example, it may not be necessary to decide on the boundaries of the relevant market, when the Authorities would reach the same conclusions as to the effects of the merger under different market definitions.' Office of Fair Trading and Competition Commission (2009), 'Merger Assessment Guidelines: Consultation Document', April, para 4.48.
[3] Small but substantial, non-transitory increase in price.
[4] For example, *Long Clawson Dairy/Millway Stilton*, cleared by the Competition Commission in 2009, and *Homebase/Focus*, which was cleared by the Office of Fair Trading in 2008.

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

Other articles in the September issue of *Agenda* include:

- **separating incumbents: panacea or a sledgehammer to crack a nut?**
- **bank restructuring aid in the financial crisis *Christian Ahlborn and Daniel Piccinin, Linklaters***
- **don't forget the remedies: what could competition policy learn from regulation?**

For details of how to subscribe to *Agenda*, please email agenda@oxera.com, or visit our website

www.oxera.com

© Oxera, 2009. All rights reserved. Except for the quotation of short passages for the purposes of criticism or review, no part may be used or reproduced without permission.