

## A question of balance: Comments on a proposed new test for UK merger control

1. This, for example, was a question addressed in the report commissioned by DG Competition, "Competition Policy for the Digital Era"; by Jacques Crémer, Yves-Alexandre de Montjoye and Heike Schweitzer, published in April 2019, henceforth "Crémer et al".

2. This may be due to gaps in the jurisdictional thresholds or the substantive tests. This Brief focuses on the latter.

3. Unlocking digital competition, Report of the Digital Competition Expert Panel. <https://www.gov.uk/government/publications/unlocking-digital-competition-report-of-the-digital-competition-expert-panel>

4. In practice, the difference between the two tests is debatable. As we discuss below, in the UK the CMA disagrees with the Furman Report's suggestion of changing the substantive test, in part, because it considers itself to be already armed with sufficient legislative tools. Crémer et al argue that the EU merger test does not need to be changed arguing that instead DG Competition should update its toolkit of theories of harm in some specific circumstances relating to acquisitions by dominant firms of fast-growing start-ups.

### Introduction

Digital markets are under intense scrutiny. In the merger enforcement arena, for example, it has been argued that the tests for assessing mergers are not fit for purpose, leading to under-enforcement.<sup>1</sup> In particular, there is a concern that competition authorities have insufficient scope to block acquisitions of innovative potential entrants that may, absent the merger, have become a disruptive competitive influence and a spur for increased innovation in digital markets.<sup>2</sup>

Concerns of this nature have resulted in significant reforms to the UK merger regime being proposed in a recent report prepared for the UK Government by a digital competition expert panel, headed by Professor Jason Furman ("the Furman Report").<sup>3</sup> One of the many recommendations in this report is to replace the test of harm currently applied by the UK Competition and Markets Authority ("CMA"), i.e. whether a merger leads to a substantial lessening of competition on the balance of probabilities ("BoP"), with a new test based on the "balance of harms" ("BoH"). Under this new test, the CMA would undertake a forward looking "cost-benefit analysis" of mergers reflecting both the *probability* that a wide range of pro and anti-competitive effects may arise from a merger and the *magnitude* of these effects. This, it is argued, would permit the CMA to intervene against mergers that give rise to a small risk of large scale detriment (so-called "low probability, high impact" events).<sup>4</sup>

This Brief discusses these proposed changes to the merger test. First, we compare the BoP and BoH tests in theory. Second, we note that despite its theoretical merits, there are a number of practical challenges in implementing the BoH test. Finally, we argue that balancing harms and benefits should not focus only on the harm side of the equation. Any change in the test to give greater weight to lower probability bad outcomes (e.g. lost future competition) should treat lower probability good outcomes (e.g. rivalry enhancing efficiencies) and countervailing constraints (e.g. lower probability, large scale entry or expansion of rivals) consistently. Only then can a BoH test be said to offer a truly balanced assessment of mergers.

### The theoretical merit of the BoH test

In theory, the BoP test asks whether a harmful outcome is more likely than not. A BoH test is different in that it permits harmful outcomes to be taken into account even if they are unlikely. This is done by weighting their impact by the probability that they occur.

To explain the difference it is helpful to consider a hypothetical example of a merger where an acquirer with market power purchases an innovative start-up (the target) that may, at some point in the future, have entered the acquirer's market (if not acquired). Consider the following three possible outcomes:

- **Bad:** Absent the merger the target would have disrupted the acquirer's market power. The merger prevents this from occurring and leads to consumer welfare falling by 100.
- **Neutral:** Absent the merger the target would not have entered the acquirer's market and the merger would not generate any efficiencies. The merger does not impact on consumer welfare.
- **Good:** The merger gives rise to synergies that increase consumer welfare by 20.

5. The balance of harms is in essence an “expected consumer welfare” test which is arguably a better name since it involves balancing both benefits and harms.

6. For Merger 1, the bad outcome arises with 5% probability and causes a loss of 100. Therefore, the probability weighted impact of that event is -5. The neutral outcome has no impact on welfare and so its probability weighted impact is zero. The good outcome increases welfare by 20; it occurs with 40% chance and so its probability weighted impact is 8. Adding these together we get a gain of 3 (i.e.  $-5 + 0 + 8 = 3$ ). For Merger 2 the impact is negative ( $-10 + 0 + 7 = -3$ ).

7. Since the neutral outcome is more likely than not (i.e. occurring with 55% probability) neither merger would harm consumers on the balance of probabilities.

8. See page 11 and paragraph 3.100.

9. Furman Report paragraph 3.89.

10. The example above was simplified for ease of exposition. In a full-blown assessment, we would, inter alia, also need to consider the scope for disruptive entry by other start-ups and the possibility of beneficial or harmful effects in related markets.

To help compare the BoP and BoH tests, we consider two different mergers. Merger 1 involves the bad outcome arising with a 5% probability. Merger 2 is associated with the bad outcome arising with a slightly higher probability of 10% and a slightly lower probability of efficiencies. The most likely outcome in both cases is neutral (55%). The welfare impact of each outcome and their associated probabilities are set out in Table 1 below. The penultimate row shows the balance of harms.<sup>5</sup> It weights each welfare impact by the chance of that impact arising and then adds up all these probability-weighted impacts.<sup>6</sup> The final row shows the balance of probabilities (i.e. whether the merger is more likely than not to be harmful).<sup>7</sup>

**Table 1: Expected consumer welfare example**

Outcome	Welfare impact	Merger 1	Merger 2
Bad	-100	5%	10%
Neutral	0	55%	55%
Good	20	40%	35%
Balance of harms (expected change in consumer welfare)	-	Positive	Negative
Balance of probabilities		Not harmful	Not harmful

In the case of Merger 1, it is highly unlikely that the merger would remove a potential competitor; this occurs only in the bad scenario, i.e. a risk of just 5%. Further, the balance of harms is positive (i.e. expected consumer welfare goes up as a result of the merger). Therefore, the BoP and BoH tests would give the same result – clearance.

In the case of Merger 2, the tests point in different directions. As with Merger 1, the most likely scenario is neutral and the next most likely scenario is good for consumers. However, the bad scenario is now slightly more likely than was the case in Merger 1, while efficiencies are slightly less likely. It remains the case that a harmful outcome is not likely to arise and, on this basis, Merger 2 would in principle be cleared on the BoP test. However, because the detriment is so great in the bad scenario, the change in expected consumer surplus is negative and so Merger 2 should (in theory) be blocked. For this reason, the Furman Report argues that the economically correct approach is the BoH test.

## Challenges applying the BoH test to digital markets

The Furman Report advocates that the BoH test should be applied in all markets, but the driving force for the test is the expert panel’s concern about under-enforcement in digital markets.<sup>8</sup>

While sound in theory, the problem with the BoH test in practice is the need to identify a range of possible future outcomes of a merger, the likelihood that each outcome will arise, and the magnitude of the impact of each outcome on consumer welfare. While this is partly true of the BoP test too, a key reason for advocating the BoH test is to factor into the assessment low probability, high impact events.<sup>9</sup> This means that there must be some attempt to assess both the likelihood and magnitude of various “good”, “neutral” and “bad” scenarios and to reflect those in an assessment of transactions.<sup>10</sup> Put simply, difficult-to-quantify low probability events can be set aside under a BoP test, but those probabilities (and the magnitude of the associated impacts) are critical under a BoH test.

---

11. See page 3.

---

12. See page 123.

---

13. See CMA's response to the Furman Report, 21 March 2019.

---

14. Furman Report paragraph 3.89.

---

15. Changing the merger regime to give competition authorities substantially greater discretion to employ such theories of harm may lead to over-enforcement, particularly in areas where no under-enforcement problem has been identified.

---

16. See paragraphs 3.106 and 3.38.

---

17. See "A Quick Guide to UK Merger Assessment", March 2014, CMA 18, which states that "for the CMA to give weight to efficiency arguments, it must have compelling evidence that such efficiencies not only result directly from the merger itself, but also that they will be timely, likely and sufficient to prevent an SLC from arising".

---

18. The Furman Report suggests that the need to weigh up efficiencies might be reduced by adopting a "substantiality" threshold that "implicitly allows for a certain level of merger efficiencies, without these having to be demonstrated" (paragraph 3.98). While a substantiality threshold has merit in the sense that under a BoH test any expected harm net of expected benefits should be substantial before intervention takes place, it does not resolve the difficulty of weighing low probability, high impact events. This is important because it is precisely these events that will tip the balance between what is not an SLC on a BoP test but is worthy of intervention under a BoH test.

Referring to an error cost framework (which is, in essence, the same as the BoH concept) it is notable that Crémer et al state: "what economists would call the 'expected' impact on consumers will be too complicated to compute in many cases".<sup>11</sup> In relation to weighing up efficiencies and anti-competitive effects, they also state: "The challenge of balancing these different effects, which are hard to estimate with any degree of certitude, should not be underestimated. There will be uncertainty in all directions and making a balanced error cost analysis will require great care and intellectual discipline".<sup>12</sup>

Herein lies the irony that, of all sectors that competition authorities assess, perhaps the hardest in which to conduct a strict balance of harms assessment are digital markets. As the CMA has acknowledged, the future development paths of these markets are hard to predict.<sup>13</sup> It may be particularly difficult, for example, to quantify with any reasonable degree of confidence the impact of the merger on innovation or privacy. Nonetheless, the Furman Report envisages these factors being taken into account.

*"To continue with the example of Facebook and Instagram, a balance of harms approach would consider the potential harm from losing a powerful rival to Facebook's social network. This harm would include the forgone benefits from the competition that a rival could bring, for example through increased quality and availability of innovative new services, lower costs of digital advertising being passed through to consumers, and greater privacy protection. Importantly, the scale of these potential impacts would be factored into the decision to a greater extent than is possible under the current test".<sup>14</sup>*

The difficulty of assessing these important factors does not necessarily mean that they have no place in a merger assessment. However, if these factors are taken into account, careful consideration must be given to the real risk of opening the floodgates to speculative theories of harm that lack evidential support.<sup>15</sup>

## BoH: a truly balanced approach

Importantly, the Furman Report finds that most mergers in digital markets will be competitively benign and that some may lead to significant efficiencies in the form of lower prices and increased innovation.<sup>16</sup> Under a BoH test, both the scale and probability of these benefits need to be identified and weighed up against the potential harms.

Herein lies an important problem. It is well-known that, to date, the CMA (and the European Commission) have placed limited weight on efficiencies claimed to arise from mergers.<sup>17</sup> Yet it would be wholly unbalanced if, in applying the new test, the CMA were to set a lower bar when analysing the harm side of the analysis whilst at the same time requiring merging parties to substantiate merger-specific benefits to the tough legal standard required today.

After all, if "unlikely but significant" detriment is to be factored in to the harm side of the equation, why not also take account of beneficial events? A strictly applied BoH test would weigh up not only likely efficiencies but also significant synergies that may not be likely but nonetheless have a reasonable chance of occurring.<sup>18</sup> In a similar vein, countervailing constraints that may mitigate against bad outcomes (e.g. lower probability large scale entry and expansion by third party rivals) should also be reflected fully in a BoH assessment.

In theory, compared to a BoP test, a BoH test could either increase or reduce intervention depending on how the impact of low probability beneficial and harmful events are weighed up. Incorporating the BoH concept into UK competition law and practice in full would require a fundamental rethink of how these factors are assessed.

---

19. CMA response to the Furman Report, 21 March 2019. While the CMA does not explain this point in detail, its concern may reflect a view that the BoH test would make intervention more likely across all industry sectors, yet the concern with under-enforcement has been raised only in relation to digital markets.

## Conclusion

The Furman Report argues that the UK merger regime requires a new test, not just for the digital sector but for all markets. While its recommended BoH test makes sense as a matter of theory, in practice it will be hard to apply with confidence, particularly in digital markets.

In response to the Furman Report, the CMA highlights that it is live to the risk of under-enforcement in digital markets and already armed with the legislative tools to take on the challenge in the mergers arena. The CMA further warns that the BoH test could have profound implications beyond digital markets, substantially increasing the number of interventions in more traditional areas and bringing about “a fundamental shift in merger policy” that should not be underestimated.<sup>19</sup>

The CMA’s opinion that the BoP test is sufficient suggests that it believes it already has the tools to block a merger on the basis of a low probability, high impact event. If so, there is no need to change the test. Moreover, if the CMA took such a decision, and it was appealed by the merging parties, the extent to which a gap in the law really exists would be revealed.

In any event, any attempt to plug such a gap with a BoH test must be thought through carefully. A new test should ensure a consistent treatment of evidence on potential future outcomes, whether harmful or beneficial. For example, even if it can be shown that a merger would remove a target with a material prospect of disrupting the acquirer’s market power, consideration should also be given to the scope for other potential entrants to do the same and thereby sufficiently maintain the post-merger threat of potential competition. Further, efficiencies that may not meet the tough legal standard today but that are nonetheless reasonably likely should be given a fair hearing. If the test is expanded to take into account low probability, high detriment events, it should also factor in low probability, high benefit scenarios. Only then can the BoH test truly be said to offer a balanced assessment of mergers.