September 2008

RBB Brief 30

RBB | Economics

When One is Enough? – Effects-based and efficiencies analyses in practice

After a Phase II inquiry, the Dutch competition authority NMa cleared on 28 August 2008 the acquisition of Gouden Gids, a Dutch on-line and print directory owned by Truvo, by European Directories, publisher of rival on-line and print directory De Telefoongids.[1] The transaction led to the integration of the directory activities of De Telefoongids and Gouden Gids. De Telefoongids and Gouden Gids were the only two national, door-to-door distributed directories in the Netherlands.

The case is interesting, firstly because an effects-based assessment by the NMa paved the way for clearance of this, at first sight, merger to monopoly, and secondly because the likely benefits to advertisers resulting from the merger played an important role in the clearance decision. This case is therefore one of the few exceptions where an efficiency defence had a material impact on the outcome of a merger case.

This Brief explores the factors that led to this unusual result, and also draws some parallels with the OFT's clearance of a merger between two commercial radio stations, in which efficiency issues also played a key role.

Background

Directories contain lists of businesses and institutions categorised by type of business that allow users to find suppliers of products and services. Consumers obtain print and on-line directory information for free. Businesses and institutions are automatically listed for free but if they want to expand the information and enhance visibility they can opt to buy advertising space, and thereby increase the chance that directory users will find and choose them. Publishers of directories obtain the vast majority of their revenues from advertising (which is why the directories market is also referred to as the market for classified directory advertising services).

De Telefoongids and Gouden Gids are the two main print and on-line directory publishers in the Netherlands. Together they account for over 90% of the revenues in a narrowly defined market for classified directory advertising. Since users of directories normally consult only one directory for a particular search, and because both Gouden Gids and de Telefoongids account for a very significant share of directory usage, many firms that rely on directory advertising for the generation of business leads (such as 'first aid' type of businesses like plumbers) advertise in both directories.

The directory market in the Netherlands is characterised by a rapid shift of usage from print to on-line. The Dutch market has seen the entry of a new on-line only directory publisher and search engines such as Google increasingly offer local search functionalities which look similar to those offered by directory publishers.

The NMa's assessment

In an effort to assess the impact of the merger directly, rather than focusing on market definition and market shares, the following topics were investigated by the NMa: (1) the risk of lessening of competition due to the elimination of rivalry between the two directory providers; (2) the remaining competitive constraints on the post-merger entity from other media and 'stoppers' (advertisers that stop advertising in response to a price increase); and (3) benefits to advertisers resulting from the integration of the two directories.

1 See for the decision http://www.nmanet.nl/Images/6246BCV_tcm16-119688.pdf. RBB Economics advised both parties throughout the first and second phase inquiries by the NMa to both parties.

Lessening of competition between the parties

The NMa found in its second phase inquiry that competition between the two directory providers was limited. Such a finding appears to be at odds with the narrow relevant markets identified by the NMa in its first phase investigation, where it defined print and on-line directories as relevant markets which were essentially confined to the two merging parties. However in the second phase inquiry, the NMa observed very limited switching of advertisers between De Telefoongids and Gouden Gids. Furthermore, survey information gathered by the parties and the NMa indicated that switching is unlikely to increase as a result of relative price changes between the two firms. This resulted in the conclusion that, despite appearing to be each other's only real competitor, the two parties only exercised a limited competitive constraint on each other pre-merger.

Competitive constraint from other advertising media and stoppers

The NMa survey found that competition from other media was limited, but at the same time larger in magnitude than competition between the parties. The NMa concluded that the competitive pressure from on-line alternatives such as search engines and specialised sector-specific websites (such as websites for restaurants) would increase further in the future. Usage is already shifting from print to on-line and advertising budgets are expected to follow suit. Survey information indicated that a relative price increase for print advertising would likely accelerate such a shift.

In addition, the survey results showed that if both print advertisers would increase prices (i.e. if the post-merger entity would increase prices) a very significant proportion of advertisers would stop advertising in directories altogether without switching to next best alternatives.

The NMa concluded therefore that the post-merger entity would be unable to increase prices because of the aggregate effect of advertisers switching to other alternatives and advertisers stopping advertising altogether, without drawing conclusions as to the exact definition of the relevant markets.

In addition the NMa concluded that although some negative (price) effects for some advertisers could not be excluded, the post-merger entity would not likely be able to price discriminate between more and less price sensitive advertisers on a large scale. This is relevant because if the post-merger entity were able to target price insensitive advertisers, it could increase prices to those customers without the risk of losing advertisers (i.e. such post-merger price increases would be profitable).

Benefits from integration of directories

Post-merger, households will receive only one, instead of two directories and the on-line directories will also be integrated. The NMa found that advertisers will benefit significantly from this integration, which is a direct effect of the merger. Customers that, pre-merger, advertise in only one directory ('non-overlap advertisers') will gain the 'audience' of the other directory. In addition, customers that currently advertise in both ('overlap advertisers') will only have to advertise in one directory post-merger. Due to integration of the two directories, directory usage for non-overlap advertisers will go up. And since the prime reason to advertise is to reach potential customers, non-overlap advertisers will get more value for money, assuming advertising prices remain constant. Overlap advertisers on the other hand, will have to spend less for the same reach, again assuming prices remain constant post-merger.

The relevant question is hence whether post-merger price increases are likely to be of a magnitude that would offset the positive effects of integration. The parties argued that such post-merger price increases would have to be very significant and are therefore unlikely. They also pointed to the fact that the post-merger integration plans assumed a significant reduction in revenues from overlap advertisers.

The NMa agreed that the possible disadvantages of integration – price increases and 'crowding out'[2] – are unlikely to undo the likely benefits for advertisers. It therefore concluded that, although it could not be ruled out that a small number of advertisers could be worse off as result of price discrimination by the post-merger firm, a large group of advertisers stands to benefit from the integration of the directories. Hence the NMa concluded that, on balance, the overall effects of the merger are likely to be positive.

Scope for efficiency defence in media mergers

The clearance of the directories case by the NMa relies considerably on the likely benefits for advertisers that result from the merger. This can be regarded as a de facto acceptance of an efficiency defence, and is therefore one of the rare occasions in which merger related efficiencies have had an important impact on the outcome of a merger assessment by a competition authority. The question that emerges therefore is what distinguishes this case from other merger cases?

Although the efficiencies are on the demand side (advertisers' budgets), rather than classic supply side efficiencies (cost reductions in production), the anticipated reduction in revenues from overlap-advertisers was only affordable for the merged entity because of the savings on operational costs (printing, distribution and sales) achieved by the merger.

Authorities tend to attach greater weight to the likelihood of any adverse effects rather than possible efficiencies that could materialize as a result of a merger. In addition, an efficiency defence is likely to be judged according to a 'sliding scale': the greater the likelihood and magnitude of anti-competitive effects, the greater and more powerful consumer benefits should be. Accordingly, mergers that create concentrated market structures tend to require compelling efficiency arguments to convince authorities to clear a merger.[3] Three conditions are used to test efficiency defences: efficiencies should be (i) demonstrable (should undoubtedly arise within a reasonable period of time); (ii) merger specific (cannot be achieved in a different way) and (iii) likely to be passed on to consumers.[4] Applying these requirements to the Dutch directories case suggests that media mergers in which the merging parties rely on advertising revenues may be better suited for successful efficiency claims than other mergers. Advertisers normally seek to reach as many potential customers as possible with their advertising message: the larger (and focused) the audience is, the better. A demonstrable and merger specific effect of combining the activities of De Telefoongids and Gouden Gids is that advertisers will reach a larger audience, and in this case without dilution of the focus – the two directory providers target the same user groups. And pass-on is immediate – there is no need to show how cost advantages in production would culminate in lower prices. In the directories' case it is the reverse; there was a need to show that the tangible benefits would not be undone by the (speculative) threat of higher prices.

The UK radio case

The Dutch Directories case is not the only recent media merger in which an efficiency defence has been accepted. A recently cleared UK radio merger displays some parallels.

On 8 August 2008 the UK Office of Fair Trading (OFT) cleared the acquisition by Global Radio UK Limited (Global) of GCap Media plc (GCap), both active in commercial radio.[5] In the London area, stations of the parties overlapped and the aggregate market share was estimated to be around 50 percent. Initially the OFT was sceptical and considered that (i) adverse effects would directly harm advertisers and (ii) possible efficiency gains '…while theoretically possible, must meet stringent efficiency evidence requirements rather than merely be assumed to be sufficient.'[6] Ultimately the OFT acknowledged however that the likely efficiencies resulting from the merger tipped the balance in favour of the parties.

2 Crowding out refers to the idea that the value of an advertisement decreases when it is surrounded by more other (competing) advertisements.

3 Since the NMa found that there was a limited risk of post-merger price increases, the NMa was likely more receptive to the efficiency defence raised by the parties and willing to weigh those efficiencies against the possible outcome that some advertisers could be worse off as a result of the transaction.

4 See also the Guidelines on the assessment of Horizontal Mergers, Official Journal, C31/5 of 5 February 2004, paragraphs 76–88.

5 OFT decision of 8 August 2008, Case ME 3638/08. See http://www.oft.gov.uk/shared_oft/mergers_ea02/2008/Global_GCap.pdf. RBB economics advised the merging parties in this case.

6 See page 13 of the OFT decision. Moreover, the OFT noted that its focus was'…consistent with previous merger enforcement in radio cases in at least the UK, Ireland, Canada and the United States.'

First, the OFT found that bundles of airtime on stations could be sold to advertisers more efficiently as a result of the merger since advertisers would only have to purchase one (larger) bundle instead of several smaller bundles from independently owned stations: the merger would realise one-stop shopping transaction cost savings.

Second, different target audiences (e.g. younger versus older people) were regarded as complementary audiences. Because of likely Cournot-effects, the OFT argued that the merged entity would have an incentive to lower prices.[7]

Finally, the merged entity would have an incentive to reposition radio stations to focus on more narrowly defined target audiences. When radio stations are independently owned and competing, they commonly target the 'median listener', i.e. they offer a rather general entertainment profile to appeal to as many listeners as possible. By contrast, when a set of stations has one owner, this owner would be able to cater more specifically to different listener profiles by differentiating the stations. It does not risk losing listeners to the competitor by not positioning 'in the middle'. Consequently, advertisers will benefit from better value for money since airtime to communicate a certain message is more likely to be received by the target audience.

As was the case for directories, the radio efficiencies outlined pass the test of demonstrability, specificity and pass-on relatively easily. Whereas in the directories case the integration of books leads to either an enlargement of the audience or spend reduction, the joint ownership of radio stations allows for a repositioning of radio stations which allows advertisers to reach their target audiences more effectively (and to profit from reduced pricing as a result of the Cournot-effect).

What the cases also have in common is that the user/listener side of the market stands to benefit as well: directory users now find all advertisements in one directory, rather than spread over two, and listeners will benefit from the better targeting of radio stations. Hence, both sides of the market are direct and simultaneous beneficiaries of the merger.

Conclusion

Contrary to popular belief that the efficiency defence would remain a hollow promise, the NMa and the OFT have shown in two recent media mergers that merger efficiencies can help in obtaining merger clearance. However, it is clear that media mergers may be special because what is good for the merging parties is good for the advertisers and vice versa.

The directories case of the NMa is 'extra special' because the assessment skipped the stage of defining the relevant market and calculating market shares, because of its limited value for the assessment of the case, and focussed on looking directly at the likely positive and negative effects of the transaction. It is not surprising that the NMa needed a Phase II inquiry for such a decision, but in the end it searched and found the right answer.

7
This is because a reduction in the price of one product within a bundle of complementary products will increase demand not only for that specific product but also for all the other products included in the bundle. When one firm owns all the products in a bundle, it will reap the benefits of increased demand for complementary products, following a price reduction. By contrast, when competing firms offer the complementary products, a firm will not reap this benefit. Hence, under common ownership it is profit maximising to sell complementary products at a lower price than the sum of what products would cost under separate ownership.