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OFT/CC joint merger assessment guidelines: response to invitation to comment

RBB Economics, August 2009

1. Introduction

This note sets out RBB's main substantive comments on the draft Merger Guidelines ("Guidelines") published by the OFT and the Competition Commission ("the Authorities") in April 2009. In addition, some detailed comments are provided by way of a mark-up of the draft Guidelines document.

We welcome the provision of a consistent set of Guidelines to be applied jointly by the OFT and the CC, and agree in large part with the proposed economic approach to merger analysis set out in the Guidelines. However, the draft Guidelines raise a number of substantive concerns that we believe merit further consideration by the Authorities, and which form the focus of this note.

In summary, our primary concerns are as follows.

- We consider that the process of market definition provides an important framework for identifying at the outset of a merger investigation the immediate competitive constraints on the merging parties as well as an appropriate reference point for understanding potential competition and buyer power. As a result, we would be concerned if the Authorities' apparent intention to downplay the role of market definition were to lower the threshold for intervention by failing fully to take account of the wider market context in which proposed mergers take place.

- As regards the analysis of unilateral effects in horizontal mergers, we believe that:

  – the Guidelines would benefit from a more developed discussion of the role of, and inferences to be drawn from, an analysis of the closeness of competition between the merging parties;

  – supply-side responses (in terms of entry, expansion and brand repositioning) should be given greater prominence in the competitive assessment;

  – in contrast to the analysis of coordinated effects and non-horizontal mergers, the Guidelines provide only a cursory description of the forms of evidence, both qualitative and quantitative, that would be considered by the Authorities in merger analysis; and

  – the proposed unilateral effects analysis gives undue prominence to diversion ratios relative to other pieces of economic evidence. This would be of particular concern if diversion ratio and margin evidence is used to form rebuttable presumptions of competitive harm.

- In the assessment of coordinated effects, we agree with the apparent de-emphasis of theories of harm concerning the creation of conditions for tacit coordination, but are concerned as to the practical assessment of theories of harm that are based on the presumed existence of pre-merger coordination:

  – first, the proposed approach raises a real risk that merging parties may face a potentially insurmountable evidentiary burden to disprove allegations of pre-merger tacit coordination, based only on the presence of various broad market features that are also frequently found in highly competitive markets; and

  – second, we believe that, even in the rare event that the existence of pre-merger tacit coordination is established, it remains crucial that the Authorities carry out a proper assessment of whether the merger makes such coordination more or less likely.

- In relation to non-horizontal mergers:

  – the proposal to introduce at the OFT stage a rebuttable presumption of competitive harm once an incentive and ability to foreclose rivals have been established appears neither necessary nor helpful; where the OFT considers that it should refer a merger to the CC, this should be based on a weighting of the entirety of the available evidence rather than on (somewhat arbitrary) rebuttable presumptions, which unduly place the burden on the merging parties;

- more generally, the Guidelines require a more careful exposition of the theories of harm outlined, and should give greater prominence to the well established principle that most non-horizontal mergers are pro-competitive or benign in their effect; finally,

- we believe that the Guidelines would benefit from a recognition that, unlike the case of horizontal mergers where the assessment of efficiencies as a countervailing factor to a potential SLC has clear logic, such a two-step approach is unlikely to be appropriate in the case of non-horizontal mergers.

These issues are discussed in turn below.

2. Market definition

2.1. Role of market definition

We recognise that market definition is not an end in itself but rather a starting point for competitive analysis. However, we are not convinced that the move from the prevailing guidance in relation to the role of market definition – and specifically the apparent intention to downplay the role of market definition – adds to, rather than reduces, the clarity of the analysis that may be expected to be undertaken by the Authorities. Rather than downplaying the role of market definition, we believe that the Guidelines should clearly recognise the importance of a well-defined relevant market as a first step in competitive assessment, for a number of reasons.

First, the process of market definition – and in particular gathering informative evidence on the scope for demand and supply side substitution – provides an important starting point for understanding the competitive effects of a merger. A rigorous attempt to define the relevant market provides an important framework for identifying at the outset the immediate competitive constraints on the merging parties as well as an appropriate reference point for understanding potential competition and buyer power. While this framework can, in theory, also be established via a direct analysis of competitive constraints on the merging parties, in practice the process of market definition provides greater certainty that the Authorities will fully consider the broad set of potential competitive constraints, and greater transparency as to the approach used by the Authorities to identify them.

Second, market shares, based on an appropriate market definition, provide an important filter for competitive analysis: if the merging parties' market shares are low, frequently no further competitive analysis will be required. In the draft Guidelines, however, an apparent tension exists between the wording of paragraph 4.49, which recognises that a market definition will be necessary to assess market shares (or other concentration measures), and paragraphs 4.47 and 4.48, which indicate that market definition analysis may not always be concluded upon. If the intention of the Guidelines is that market definition would always be conducted, but may not be concluded upon only where the likelihood of SLC is not affected by the definition adopted, then this intention could be more clearly stated.

Of course market definition should be complemented by an assessment of the limitations of market share evidence in a given industry. It is widely acknowledged that in differentiated product markets market shares may over- or under-state the magnitude of constraints between firms. Nevertheless, in a properly defined market with differentiated products, a low combined market share may still be relevant, even if the merging parties are each other's closest competitors. Unless market shares under-state by a very large degree the importance of the constraint that the merging firms place on each other, there may well still be sufficient absolute constraints from other firms in the relevant market to prevent an SLC from occurring.

2.2. Substantive assessment of market definition

In terms of the substantive framework for market definition, we note three broad points.

- First, the draft Guidelines in their current form indicate that the concept of the ‘hypothetical monopolist test’ for the purposes of market definition will be adopted “wherever it is useful and practical to do so” (4.52). Although we agree that the hypothetical monopolist test cannot be formally applied in all cases, on a conceptual level it is the leading (and arguably only) economic framework through which market definition can be properly examined. Therefore, we consider that the Guidelines should be more explicit in adopting the hypothetical monopolist test as the appropriate conceptual framework for the assessment of market definition.

- Second, we have no objection to the semantic change in respect of market definition for supply-side alternatives, from the current approach of defining markets that encompass current production and supply side substitutes, to a market defined as current production *plus* capacity that could be brought into that market in the event of a SSNIP (footnote 40). Insofar as concentration measures continue to reflect the capacity of all potential suppliers, the substance and outcome of competitive assessment will be unaffected by the new approach. However, the role of supply-side substitution in market definition is currently unclear, and we think it is important to guard against a real risk of under-emphasising the importance of supply side constraints in merger assessment.

- Little clarity is provided as to the approach that may be adopted to “other aspects relevant to market definition” (paragraphs 4.72 et seq.); as such, it is not clear that this section adds any practical guidance. How and when, for instance, will a review of firms’ bargaining strength replace standard SSNIP test analysis? Similarly, what assistance is provided by the statement that chains of substitution cannot be assumed but will be assessed within the hypothetical monopolist test?

3. Analysis of horizontal mergers

Since horizontal mergers account for a large majority of the cases considered by the Authorities, the guidance offered in this respect is of crucial importance in practice, and would in our view benefit from substantial revision from the currently proposed draft.

As a general comment, we note that the text of the Guidelines (particularly in relation to the assessment of unilateral effects) is very much focussed on the analysis of differentiated retail markets. By contrast, the Guidelines offer little practical guidance as to the Authorities’ assessment of homogeneous goods markets, markets characterised by significant innovation or markets in which capacity choices represent the key competitive dynamic.

3.1. Unilateral effects

3.1.1. Closeness of competition

Although we agree with paragraph 4.102 that unilateral effects in differentiated product markets are more likely to arise in the case of mergers between firms that produce close substitutes, it cannot be assumed that closeness of competition is sufficient to imply an SLC. For example, an SLC may be unlikely if, even though closest competitors:[1]

- the merging parties are not *close* competitors (that is to say, while the merging firms produce substitute products, the most important constraint is not that consumers would buy the product of the other party but that they would leave the market entirely); or

- many other competitors are also very close to the merging parties in product and/or geographic space such that the merging parties would not be able to realise a post-merger price increase (other than a very small change in their relative prices) without inducing substantial switching to competitor products.

These factors are relevant even in the absence of dynamic competitor responses, such as expansion or brand repositioning noted at paragraph 4.102, and therefore the Guidelines would benefit from reference to these considerations.

3.1.2. Supply side responses

The Guidelines' framework for the assessment of unilateral effects should give greater prominence to the assessment of dynamic supply-side competitor responses. For example (and as we discuss further in the following section), it is simply not possible to conclude on the existence of a "strong indication" of unilateral effects without a detailed analysis of supply-side responses. Expansion, entry and brand repositioning allow competitors to win business from the merged group by supplying a substitute good to the merging parties' products, and therefore may prevent the merged entity from raising price, either at all or at least to a substantial degree. Understating such responses risks systematically over-predicting post-merger price increase.

At paragraph 4.187 the Authorities refer to the assessment of entry at pre-merger prices. We would emphasise that the relevant question is to assess supply side responses in the event that the merged firm attempted to sustain higher prices (or lower QRS) post-merger. In this regard, it is not meaningful to ask whether there is an incentive for firms to enter a market on current terms on which they are observed not to have entered to date. Consider, for example, a scenario in which the merged firm's attempt to raise prices alienates its customer base to a sufficient degree that entry would be attracted and the new entrant would remain viable even at pre-merger prices. That process could occur only as a result of the merged firm attempting to sustain higher prices post-merger. It would not be expected to arise if the merged firm simply

[1] Throughout this discussion, we assume that firms are defined as closest competitors where, following a price rise by one firm, the other would capture more diverted sales than any other individual firm.

maintained prices at their pre-merger levels (and thus did not harm its customers). The relevant question, therefore, relates to potential competitor reactions to attempts by the merged firm to implement higher prices post-merger.

3.1.3. Economic evidence

The Guidelines as currently drafted contain an insufficient discussion of the range of qualitative and quantitative evidence that may be used in an assessment of horizontal mergers. Customer surveys, internal documents, internal data or industry reports on pricing, customer switching or bidding patterns are often instrumental in forming the Authorities' opinions and the Guidelines should outline the forms of evidence that may be particularly formative. In addition (or in the alternative) we would suggest that the Authorities consider publishing a separate discussion paper to discuss in detail how different forms of economic evidence, including consumer surveys or natural experiments, should be used and interpreted to inform the assessment of horizontal mergers.

The proposed Guidelines display a heavy bias towards the use of diversion ratios. While diversion ratios may in some cases be a useful tool for the assessment of mergers in differentiated product markets, their value will be inherently dependent on the means by which they are derived. It is therefore vital that the Authorities maintain a balanced overview of all available evidence and check each and every form of evidence against other analyses in order to avoid unrealistic conclusions. We consider it inappropriate to prejudge assessment by identifying one form of economic analysis as preferential to alternative economic or econometric evidence. The correct approach will depend on the particular circumstances of each case.

Moreover, we have severe concerns with the Authorities' attempt to link diversion ratios and gross profit margins in order to establish a 'strong indication of unilateral effects' (paragraph 4.104).

- First, it is too narrow an approach to assert that high gross margins must indicate low price sensitivity and hence an absence of effective competition. For example, where firms compete on non-price factors (and where this involves making investments that are treated as fixed costs for accounting purposes), an accounting measure of variable cost is likely to under-state the "true" measure of marginal cost on which business decisions are made, and thus the price-sensitivity of consumers as perceived from a commercial perspective. More generally, accounting gross margins may not adequately capture the economic definition of gross margins, and consequently fail to produce reliable indications of post-merger price effects in combination with estimated diversion ratios.

- Second, estimating diversion ratios is not a trivial task. The Guidelines would therefore benefit from a detailed discussion (possibly in the context of an accompanying document on economic evidence, as suggested above) of the forms of evidence that the Authorities may use to predict sales diversion in the event of hypothetical relative price changes, and also of the potential risks associated with inferences drawn from imperfect data.

- Third, the relatively simple formulae that are typically used for calculating upward price pressure (to which we assume that the Guidelines allude) are dependent on assumptions that are often violated in practice, including, for example, the assumption that marginal costs remain unchanged as a result of the merger and that an 'average' margin is a meaningful indicator of the elasticity of demand (which will not hold for multi-product or multi-store firms). When apparently simple formulae are amended to take into account the realities described above, they may rapidly become unworkable. Yet failing to modify simple formulae to reflect market realities can lead to absurd predictions.[2]

- Moreover, the Guidelines, while providing an indication that the OFT would mechanistically link diversion ratios and gross margins, are silent on the precise manner in which such a link would be made. In particular, further information would be useful concerning:

  – the threshold at which the Authorities would consider competition concerns to be raised (analogous to market concentration safe harbours); and

  – the calibration of the models used to link diversion ratios and gross margins, including relevant assumptions concerning the shape of the demand function, the appropriate measures of cost, or cost symmetry between the merging parties.

  As such, the Guidelines provide limited guidance as to the how this approach will be applied in practice.

- Finally, without an assessment of the dynamic competitor responses that are not considered in this form of analysis, we do not see how a "strong" indication of unilateral effects can be assumed. To assume that competitors do not react to price increases by merging firms (and that customers do not react in turn to changes in firms' offers) would, as described at section 3.1.2, above, disregard one of the most crucial aspects of unilateral effects analysis.

These factors also lie at the root of our concerns about the OFT's recent approach of applying 'rebuttable assumptions' on the basis of diversion ratio and gross margin evidence. We do not dispute that diversion ratios and margins can be useful as part of an overall economic assessment, but see no reason why they should be given prominence, over other, *equally* or *more informative*, evidence. In particular, it seems inappropriate that the OFT places the burden of assessing supply side responses solely on the merging parties, given that without an understanding of the supply side responses, no meaningful conclusion on unilateral effects can be reached.

[2] The dangers of applying the diversion ratio analysis in this way (and as a primary piece of evidence) were illustrated in Somerfield/Morrisons, for instance, where a similar analysis predicted price increases of up to 1898%, contrary to price concentration studies that showed prices and margins less than 5% higher in areas of monopoly relative to those local areas that had two or more competing fascia.

3.2. Coordinated effects

We understand why the Authorities would wish to place greater emphasis on the existence of pre-merger tacit coordination in the assessment of coordinated effects (paragraphs 4.120 and 4.121), given the practical difficulty in establishing mergers as "tipping points" from competition to coordination. If it were possible to establish pre-merger tacit coordination in a robust empirical manner, theories of harm based on "strengthening" tacit coordination would certainly be less speculative than those that presume "creation" of tacit coordination.

However, there are substantial practical difficulties associated with identifying and substantiating pre-existing coordination, since observed market evidence that is consistent with tacit coordination will nearly always also be consistent with effective competition. Consequently, great care should be taken when setting the evidentiary thresholds required to substantiate a finding of pre-merger coordination. Furthermore, even where pre-existing coordination has been established, it cannot be presumed that a merger will necessarily create conditions that are more conducive to coordination.

Turning to the first of these points, we expect that the Authorities, particular at the OFT stage, would rely on the so-called "checklist" approach, which looks at factors which may make coordination more likely, such as high concentration, transparency, symmetry, product homogeneity, etc. In our view, however, the "checklist" approach is better at ruling coordination 'out' than 'in'. By itself the checklist provides no basis for assessing those industries in which both 'plus' and 'minus' characteristics are present; for example, a merger in a market which fulfils many of the conditions conducive to tacit coordination but is characterised by easy entry or easy expansion by existing smaller firms is unlikely to give rise to concerns of coordinated effects. Certainly, a checklist approach cannot provide substantive proof that pre-merger coordination exists.

Of similar concern is the claim that it can be "especially valuable" to consider whether "market outcomes pre-merger such as pricing and market share may be hard to reconcile with non-coordinated behaviour" (paragraphs 4.119 and 4.120). As noted above, observed market evidence consistent with tacit coordination will also in most instances be consistent with effective competition. It is hard to believe that there will be many cases where observations on price and market share alone will be sufficient (or even pivotal) in determining that coordination has taken place.

Such approaches to 'identifying' pre-merger coordination are particularly problematic because they provide little or no scope for the parties to present rebuttable evidence. For example, if a market is characterised by homogenous products, it cannot be denied that products are indeed homogenous. But the presence of product homogeneity cannot by itself imply that firms are tacitly coordinating - indeed, homogeneity of products is a factor that will typically lead to relatively intense competition. Likewise, symmetry, transparency and spare capacity are all often associated with highly competitive markets yet are also often found on the "checklist" of features that may facilitate coordination. Consequently, there is a real risk that the Authorities will place a potentially insurmountable evidentiary burden on the merging parties to prove the *absence* of pre-merger tacit coordination.[3]

Moreover, even in the rare event that pre-merger tacit coordination is established, it cannot be assumed that a merger will necessarily strengthen, rather than destabilise, coordination. Therefore it remains crucial that the Authorities carry out a proper assessment of whether the merger makes such coordination more or less likely.

While mergers reduce the number of firms in the industry (widely regarded as a 'plus factor' for coordination), the other changes in industry structure brought about by mergers may have ambiguous effects on the scope for coordination. As paragraph 4.121 notes, mergers may substantially change the structure and scale of the merged firm, which may reduce symmetry in the market and thereby reduce the incentive or ability to reach or maintain a tacit agreement. Similarly, one of the main difficulties in achieving successful tacit coordination (and one that could be more explicitly acknowledged in the Guidelines) is the need for communication between the coordinating players. To the extent that a merger potentially disturbs an alleged coordination pre-merger equilibrium, the Authorities (and certainly the CC) should still determine how and whether firms would be able to communicate and agree on a post-merger coordinated outcome.

4. Analysis of non-horizontal mergers

We broadly agree with the Guidelines' approach to the assessment of input foreclosure, although our accompanying detailed comments contain various suggestions for changes or additions to the text. As regards customer foreclosure and conglomerate theories of harm, we consider that the Guidelines do not provide a clear exposition of the theories of harm. Moreover, we consider that it could be further stressed, throughout the document, that most non-horizontal mergers are generally benign or pro-competitive and that it is only in the minority of cases that competition concerns are likely to arise.

In particular, we highlight three key features of the current Guidelines that the Authorities may wish to consider further:

- first, whether it is appropriate for the OFT to adopt a rebuttable presumption of competitive harm where incentive and ability to foreclose rivals have been established;
- second, whether the Guidelines should provide a more detailed discussion of the various theories of harm, and of the assumptions that underpin them; and
- finally, whether a two-step approach to the assessment of efficiencies is appropriate in the case of non-horizontal mergers.

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3 It could be argued that where firms have engaged in explicit coordination, then it can more easily be assumed that current observed behaviour represents tacit coordination. However, the counter argument is that if firms needed to engage in illegal explicit coordination then this would indicate that tacit coordination was not feasible. That is to say, coordination is not feasible without explicit communication.

As a general point, we also consider that the definition of some of the key terms applied would benefit from clarification (and possibly greater alignment with the terminology applied by DG Competition).[4]

4.1.1. OFT's rebuttable presumption of competitive harm

The Guidelines state that the OFT may presume that '[input] foreclosure will also have an adverse effect' if it finds that there exist both an incentive and an ability on the part of the merged firm to engage in input foreclosure (paragraph 4.145). While we understand that there are limits, in terms or resources and timescales available, to the breadth and depth of the issues that the OFT can consider in a first phase merger inquiry, we are not convinced that this rebuttable presumption is either necessary or appropriate.

First, as the Guidelines recognise at paragraph 4.139, the profitability of foreclosure and its likely impact on end consumers are likely to be closely related. Therefore, it appears unlikely that the OFT would be able to arrive at a more robust conclusion with respect to the incentives to foreclose, than with respect to the effect on consumers of foreclosure. Indeed, it is not clear from the Guidelines why the approach for assessing the potential anticompetitive effect of foreclosure should be different from the approach for assessing the incentive and ability to engage in foreclosure. While the steps may be somewhat sequential, it is not clear that one step is necessarily easier than the other.

Second, the OFT, given its access to confidential third party information, may well be in a better position than the merged firms to consider the potential anticompetitive effects of the input foreclosure. As a result, a rebuttable presumption that places a burden of proof on the merging parties is unlikely to be appropriate. Certainly, this appears to be an area of enquiry where competitor complaints might be expected to be most developed, if they are to be considered credible.

The comments in this section apply equally to the proposed rebuttable presumption of anticompetitive effects that the Guidelines propose the OFT make in relation to customer foreclosure and bundling, tying and portfolio effects in conglomerate mergers. In fact, because in the latter cases the theories of harm are not clearly set out, it is all the more dangerous to employ a rebuttable presumption of harm. Take mixed bundling, for example, which will lead to a least some groups of buyers receiving lower prices; if mixed bundling is profitable post-merger, is it appropriate to have a rebuttable presumption that this outcome would be harmful?

In short, where the OFT considers that it should refer a merger to the CC, this should be based on weighing the evidence in the round – there is no need for somewhat arbitrary rebuttable presumptions.

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[4] For example, it is not clear whether "total foreclosure" is defined in the Guidelines as a situation where downstream rivals are forced to exit the market, or where the merged firm refuses to supply downstream rivals *with the consequence* that they exit the market. We note that (i) refusal to supply does not necessarily lead to exit by rivals, but will frequently (at most) increase the downstream rivals' prices; and (ii) DG Competition defines total foreclosure differently again, i.e. as 'refusal to supply' (regardless of downstream consequences). Also, the definition of diagonal mergers at 4.168, appears to describe a horizontal concentration, since it involves the merger of an upstream firm supplying an input to its downstream subsidiary, and a downstream rival – see detailed comments.

4.1.2. Foreclosure theories

We note that the Guidelines tend towards over-inclusion of potential theories of harm, even if some of these are somewhat speculative and certainly unlikely. While we recognise that the Authorities' desire to retain flexibility makes some element of over-inclusion inevitable, if the Guidelines are to provide useful guidance, many of the theories of harm that have been outlined require more careful exposition. We have included a number of suggestions to this effect in the detailed commentary.

Moreover, given the fact that non-horizontal mergers are in most cases pro-competitive or benign in their effect, we would recommend that the Guidelines explicitly highlight those theories of harm that may be expected to arise very rarely (if ever), for example coordinated effects in non-horizontal mergers, input foreclosure in the absence of upstream market power, or foreclosure through portfolio effects.

This is especially important given the apparent proposal (at paragraph 4.14) to adopt an additive approach to theories of harm which may not individually constitute an SLC. It would be undesirable if the Guidelines inadvertently invited complainants to present a myriad of speculative non-horizontal theories of harm.

4.1.3. Two-step approach to efficiency analysis

We also believe that the Guidelines would benefit from a recognition that, unlike the case of horizontal mergers where the assessment of efficiencies as a countervailing factor to a potential SLC has clear logic, in the case of non-horizontal mergers such a two-step approach is unlikely to be appropriate.

For example, theories of competitive harm in conglomerate mergers often centre on the 'efficiency offence'; for example, that by providing a bundle of products at a lower price or better quality post-merger, the merged firm may be able to marginalise competitors, and benefit from longer term increases in price. As a result, there is a direct link between merger efficiencies (of benefit to consumers) and potential competitive harm, which requires an integrated assessment.[5]

Our concern would be accentuated if the OFT maintains its "rebuttable presumption" as regards the ability and incentive to engage in foreclosure (discussed at section 4.1.1 above), since efficiencies are then likely to be considered only at a later stage once the "rebuttable presumption" has been invoked. This places an undue burden on the parties to overturn a presumption of harm, without giving due regard to the fact that factors which harm competitors may ultimately benefit end customers.

[5] For a detailed discussion of efficiencies in the context of non-horizontal mergers, see "The Efficiency-Enhancing Effects of Non-Horizontal Mergers", Report by RBB Economics for DG Enterprise, European Commission, 2005.