RESPONSE TO THE COMPETITION COMMISSION'S INITIAL CALL FOR COMMENTS ON ITS GUIDELINES FOR MERGER REFERENCES

1. INTRODUCTION

1.1 Ashurst welcomes the opportunity to provide outline comments in advance of the review by the Competition Commission (**"CC"**) of its guidelines for merger references. After almost five years' experience of applying the Enterprise Act 2002 (the **"Act"**), we agree that a review of the guidelines is appropriate and desirable. Since a full consultation is also envisaged on the eventual draft text of the revised guidelines, our response focuses on thematic issues rather than detailed commentaries or suggestions for revised text.

1.2 Before commenting on the contents of the existing guidelines, we have two overarching comments to make, firstly concerning the authorship and scope of guidelines in relation to the merger control provisions of the Act, and secondly in relation to the purpose and approach of the guidelines.

2. AUTHORSHIP AND SCOPE OF MERGER GUIDELINES

2.1 The fact that UK merger control is split between two bodies, namely the Office of Fair Trading (**"OFT"**) and the CC, means that there have to date been two sets of guidelines. We welcome the recent decision of the OFT and CC to produce joint guidelines in relation to merger control and consider that this approach will increase clarity and consistency (the OFT and CC's guidelines are currently quite different in many respects). Whilst we acknowledge that separate guidelines may still be necessary on those procedural issues to which the identity of the body acting is directly relevant, we would welcome a joint approach by the OFT and the CC wherever practicable and in particular in relation to all issues where the identity of the body is not relevant to the outcome (for example, on points of law such as issues of jurisdiction and in relation to all aspects of substantive assessment). That point having been made, this response is written by reference to the existing CC merger guidelines, and we will not refer further to the intended move to combined/joint guidelines in the remainder of this document.

2.2 Since the substantive assessment of mergers is based on economics principles of universal application which are typically neutral as to jurisdiction, we would also welcome an approach which has close regard at least to the European Commission's Guidelines on the assessment of horizontal mergers[1] and of vertical and conglomerate mergers[2], and possibly also to the merger guidelines issued by the US competition authorities.

3. THE PURPOSE OF THE GUIDELINES AND THE ELUCIDATION OF PRINCIPLE WITH EXAMPLES

3.1 In reviewing its guidelines, the CC will no doubt wish to maximise their usefulness to the stakeholders for whom they are written.

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[1] Commission's Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings (OJ 2004 C31/5).

[2] Commission's Guidelines on the assessment of non-horizontal mergers under the Council Regulation on the control of concentrations between undertakings (not yet published in the Official Journal but available since November 2007 at http://ec.europa.eu/comm/competition/mergers/legislation/nonhorizontalguidelines.pdf).

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3.2 We would recommend to the CC comments made by the then Chairman of the OFT, John Vickers, in discussing his view of the purpose of the OFT's guidelines. He stated that guidelines:

> "*... can be seen as the economics bridge between the law and the facts of case. They say how the authorities will interpret and apply the law, particularly in respect of economic analysis, to the case facts ...*
>
> *In a world of multiple sovereign jurisdictions there is no guarantee that all will adopt the same approaches. But guidelines help expose similarities and differences – e.g. concerning approaches to market definition, entry conditions, analysis of coordinated and non-coordinated effects, and efficiencies – which it is healthy to have exposed ... Guidelines also assist the accountability of the authorities. Do we walk the talk? Without the talk it is hard to say. Guidelines provide the talk, and the language is economics.*"[3] (emphasis added)

3.3 We agree with these observations and believe that guidelines which are written with the following principles in mind will achieve the goal of being highly transparent, clear and specific:

(a) guidelines should explain clearly how "*the authorities will interpret and apply the law*". This should cover not only the way in which the economic analysis of the merger will be undertaken but should also address the pure questions of law which arise in the context of merger control under the Act[4];

(b) guidelines should provide sufficient explanation of the authority's likely approach so as to enable the parties, third parties and advisors to identify the key "*case facts*" and economic evidence required to assess the relevant theories of harm, with all such issues being judged by reference to the requisite legal standards. Clarity and transparency can only improve the quality of the evidence provided to both the OFT and CC and improve the quality of decisions. This will also assist all stakeholders in focusing their submissions to the OFT and CC; and

(c) guidelines which set out a clear "roadmap" for the competition assessment will increase "*the accountability of the authorities*" and promote consistency of decisions[5]. Whilst each case turns on its own facts, it is clear from decisions of the Competition Appeal Tribunal ("**CAT**") that guidelines are expected to be followed by the authority which issues them and there will need to be good reasons for departing from the course of action or conclusion indicated in the guidance.[6]

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3 Vickers, J. "Merger Policy in Europe: Retrospect and Prospect", 2004, ECLR 455.

4 For example, matters relating to jurisdiction, the legal standards and burden of proof in relation to a finding of substantial lessening of competition or the assessment of remedies.

5 In its recent study "Evaluation of the Competition Commission's past cases" (Competition Commission, January 2008), the CC recognised the importance of the merger guidelines, suggesting that although much of what is in the guidelines reflects what would have been best practice prior to their publication, this is not always the case (see paragraph 1.7). The evaluation report also notes that the publication of the guidelines would have enabled clearer reasoning in some of its reports that pre-dated the Act (see paragraph 1.27). The importance of the guidelines is further noted by the study in relation to the Lloyds TSB/Abbey National merger (**Lloyds TSB Group plc and Abbey National plc: A report on the proposed merger**, Competition Commission, July 2001), in respect of which it observed that the case is an example of how guidelines can help to clarify the economic analysis of a merger (see paragraph 3.43).

6 See **Unichem Ltd v OFT** [2005] CAT 8, considering guidance published by the OFT, where the CAT observed that whilst guidelines "*are no more than that*" (paragraph 199), they are widely relied on by parties and their advisers and where the authority intends to reach a conclusion which differs from the outcome which might have been expected on the basis of the guidelines, "*there will normally need to be good reasons*" (paragraph 199). Similarly, in relation to the CC's merger guidelines, the CAT observed in **Somerfield v CC**, [2006] CAT 4, that "*the CC may have been in difficulty had it departed without good reason from its guidelines*" (paragraph 98).

3.4 We would urge the CC to adopt the objectives outlined above as the relevant standards by which to judge any revised guidelines. We consider that the current version of the CC's guidelines does not fully meet the objectives of transparency, clarity and specificity and that there is therefore scope to increase the utility of the guidance in a number of areas:

(a) first, there are a number of key areas where the guidelines are silent or virtually silent. This is particularly notable in relation to the various concepts which drive jurisdiction under the Act.[7] We would welcome an extension of the guidelines to deal with all issues which regularly impact on merger assessment by the CC;

(b) secondly, in a number of places, the guidelines set out "shopping lists" of relevant factors without any comment on the interrelationship between these factors, including whether all factors are equally important or whether there is a key point of fact which will typically decide the issue or "trump" the other points[8]; and

(c) thirdly, a notable strength of the European Commission's consolidated jurisdictional notice and its horizontal and non-horizontal merger guidelines is that they illustrate general principles with reference to specific cases, both where the point was relevant and where it was not. This approach maximises the usefulness of guidelines to stakeholders, particularly where it demonstrates the application of theory in practice. The approach also assists parties and their advisers in understanding the key evidence which has driven the analysis in past cases, thereby assisting them in presenting their own case.

3.5 Having made various preliminary and overarching points, we now turn to consider the current guidelines.

4. COMMENTS ON SPECIFIC SECTIONS OF THE GUIDELINES

4A Jurisdiction

4.1 As noted briefly above, the CC's analysis of jurisdictional issues is very brief (paragraphs 1.15-1.18). In contrast, jurisdictional issues warrant a whole chapter of the OFT's guidelines (chapter 2). The fact that the CC is a second stage merger authority does not mean that it does not have to deal with the question of jurisdiction. Indeed, in contrast to the EC Merger Regulation, the Act requires the question of jurisdiction to be considered and decided upon at both the first and second stage of UK merger control. The Commission has a strict legal duty to determine this issue under sections 35(1)(a) and 36(1)(a) of the Act and the question of jurisdiction has warranted careful consideration in a number of Commission reports.

4.2 We would welcome an expansion of the CC's guidelines to include an explanation of the way in which the CC interprets and applies the following jurisdictional issues:

(a) the meaning of the concepts of:

(i) "enterprise" (for example, when will mere assets or intellectual property rights constitute an enterprise?);

(ii) "ceasing to be distinct";

(iii) "control", including the concept of "material influence";

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7 The jurisdictional issues on which fuller guidance would be welcome are outlined in section 4 below.

8 For example, no fewer than 15 factors are identified as being relevant to the assessment of coordinated effects (see paragraph 3.41 of the CC's guidelines, with other paragraphs adding other points). However, in circumstances where barriers to entry and expansion were low, then no coordinated effects would arise regardless of the presence of any of the other factors.

(iv) "associated persons";

(v) "substantial part of the UK" for the purposes of the share of supply test (for example, the CC has recently held that Slough is a substantial part of the UK[9] and that non-contiguous areas can be added together to create a cumulatively "substantial part"[10]);

(b) how UK turnover should be measured for the purposes of the jurisdictional turnover test;

(c) how the jurisdictional share of supply test should be interpreted, including examples of how the share of supply (or purchase) may involve a different measure to that of market share, based on an economic market definition;

(d) how the time limit for referring a completed merger to the CC should be assessed and the level of publicity which would start the jurisdictional clock running; and

(e) the circumstances in which the Commission might exercise its discretion to consider previous mergers involving the same parties.

4B Standard of proof and the substantial lessening of competition test

4.3 Since the time of writing the original guidance there have of course been a number of judgements of the CAT and, in particular, the **IBA Health**[11] judgment of the Court of Appeal clarifying the meaning of the substantial lessening of competition test. At present, the CC's guidance contains a single sentence stating that it will "*usually*" find a substantial lessening of competition if this is "*more likely than not*" (see paragraph 1.19): clearly, this comment requires expansion and elucidation in light of both the judicial guidance on this issue and the CC's own decisional practice.

4.4 We would therefore welcome a new section providing guidance on the CC's interpretation of the substantial lessening of competition test and the application of the standard of proof in that context, along with the related question of the quality or cogency of evidence which it requires.

4C Market definition

The SSNIP test

4.5 The guidelines state at paragraph 2.8 that the CC will normally apply the SSNIP test by reference to a 5 per cent price rise, rather than the more common 5 to 10 per cent. In this connection, we note that the OFT's merger guidelines appear to indicate a more flexible approach, referring to a "5 to 10 per cent" price increase.[12] Ashurst also notes that the CC has itself sometimes considered 5 to 10 per cent when applying the SSNIP test in merger cases.[13] It would be useful if the CC could provide further information on its rationale for preferring to use a 5 per cent increase in price, and the circumstances in which the CC is likely to consider a 5 per cent increase to be inappropriate.

4.6 In particular, the impact on consumers' purchasing decisions of a 5 per cent increase will depend on their sensitivity to price changes, whilst the impact on suppliers' profits of such an increase will depend on the gross margin being earned prior to the increase. (For

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[9] **Tesco plc and the Co-operative Group (CWS) Limited** Competition Commission, November 2007.

[10] **Vue Entertainment Holdings (UK) Ltd and A3 Cinema Limited** Competition Commission, 24 February 2006.

[11] **OFT v IBA Health** [2004] EWCA 142

[12] See paragraph 3.17 of the OFT's substantive assessment guidance for mergers.

[13] See, for example, the report on the **anticipated acquisition by Pan Fish ASA of Marine Harvest NV**, Competition Commission, December 2006, paragraph 5.35.

example, if a firm is earning a gross margin equivalent to 5 per cent of the price, then a price increase of 5 per cent would lead to a doubling of gross margins. However, if a firm was earning a gross margin equivalent to 40 per cent of price, then a 5 per cent price increase would have a much smaller impact on profitability).

4.7 In many circumstances, it may make very little or no difference whether the SSNIP test is based on a 5 per cent price increase, a 10 per cent price increase or some other number. However, if the own price elasticity of demand increases as prices rise (which is a common assumption), then estimates of substitution at prevailing pre-merger prices might well understate the substitution that might occur at higher hypothetical monopoly prices.

4.8 Moreover, price elasticities of demand might not vary in a simple uniform fashion with price, and Danger and Freech and Langenfield and Li[14] envisage a number of circumstances in which this might be the case. For some products, it is entirely possible that there might be zero or very low demand for the product or service if its price were to increase above (or perhaps even become close to) a superior quality alternative. Another possibility is that there might be a relatively small set of price-sensitive customers who would switch in response to a price increase (e.g. due to them being located in between two factories so that sources of supply from either factory are equally convenient or costly, taking into account transport times and costs) or some finite substitution to alternatives is possible (e.g. because pipeline infrastructure can import from non-local suppliers only strictly limited volumes of the relevant material).

4.9 In these latter circumstances, it is entirely possible that a 5 per cent price increase would be rendered unprofitable by the price sensitive customers switching to alternatives, but that a larger price increase might be profitable as a large customer base would be retained following the larger price increase (the price sensitive customers/volumes having already switched at a lower price increase).

Chains of substitution

4.10 In relation to chain of substitution arguments, the current guidance notes that there may be breaks in a chain of substitution. We consider that the guidelines should also note that the existence of a chain of substitution might not necessarily define the scope of the relevant market. Imagining a geographical chain of substitutes, such as retailers located along a straight road (or equally a chain of products), A to Z, E might well be constrained by competition from the adjacent retailers D and F. However, if stores (or products) D, E and F were in common ownership, there might well be scope for prices at E to be increased, since those customers lost to D and F would be retained within the group company.

4D Price discrimination

4.11 We consider that in their present form, the guidelines do not reflect the importance and complexity of the price discrimination analysis that may be required in merger cases. The scope for price discrimination is only noted briefly at paragraph 2.33 and at paragraphs 3.17 and 3.19.

4.12 A more detailed description of price discrimination is offered in the OFT's market definition guidance for cases under the Competition Act 1998.[15] This guidance defines price discrimination and describes the conditions that must hold for a firm to be able to price discriminate (such as having the ability to discriminate between customers, perhaps due

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[14] Langerfield and Li, *Critical loss analysis in evaluating mergers*, The Antitrust Bulletin, Summer 2001; Danger and Freech *Critical thinking about 'critical loss' in antitrust*, The Antitrust Bulletin, Summer 2001.

[15] Market Definition, Competition Law Guidelines, The Office of Fair Trading, 2004. See paragraphs 3.8 to 3.10.

to temporal demand, and the inability of customers to undermine price discrimination by engaging in arbitrage).

4.13 We believe that a much fuller description of the CC's approach to assessing price discrimination would assist merging parties and their advisers. Reference to past inquiries where price discrimination issues have been considered in detail would, in line with our general comments above, be particularly welcome. For example, the CC assessed price discrimination in some detail in its analysis of the merger between Pan Fish and Marine Harvest[16] and reference to this and other cases would assist stakeholders in understanding how any price discrimination issues might be assessed in their own case.

4.14 It should also be noted that anti-competitive effects of price discrimination are often identified by comparing a market structure characterised by monopoly with that of perfect competition. Froeb and O'Brien have raised questions as to whether these insights survive when considering an oligopolistic market structure.[17] Indeed, they identify circumstances where price discrimination may increase competition by allowing firms to compete for all customers (rather than exclusively marginal customers) by offering selective discounts to certain customers (i.e. those in the market area closer to a rival or to those loyal to a rival's brand). Again, discussion of how the CC will usually address such issues would be a welcome addition to the guidance.

4E The consideration of upstream and downstream competition

4.15 Apart from competition from demand- and supply-side substitutes, a supplier of goods or services may face wider competitive constraints. In markets where there is both a merchant element and integrated suppliers, the CC should have regard to the fact that merchant prices may be constrained by competition from downstream suppliers.

4.16 Competition in a market for finished products may put pressure upon customers to resist price rises for specific raw materials and semi-finished products, which would make them uncompetitive. For example, in relation to the proposed acquisition by Tessenderlo Chemie SA of the Widnes Plant and business of Atofina UK Ltd, the OFT observed that a further competitive constraint in relation to one of the overlapping products related to competition in downstream markets:

> "*There are further constraints on manufacturers of Phenylacetic Acid [used in the manufacture of penicillin] from the competitive downstream industry. The market for the downstream penicillin products was the subject of an EC merger investigation in 1998 (Case No. IV/M.1143 - **DSM/Gist Brocades**). In that case, the EC concluded that the geographic market for the end product could be considered to be worldwide. Given that this downstream product market is competitive, any action by the parties to increase the price of Phenylacetic Acid would probably result in European penicillin manufacturers losing market share to non-EU producers, thus resulting in a loss of business for the intermediate good suppliers. Hence the competitive global downstream market will act as a constraint against the EU producers of Phenylacetic Acid.*"[18]

4.17 Currently, the CC's guidelines do not address this point in any detail and we consider that the guidelines should include discussion of the CC's approach on this issue.

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16 **Anticipated acquisition by Pan Fish ASA of Marine Harvest NV**, Competition Commission, December 2006.

17 "Price Discrimination & Competition: Implications for Antitrust", speech by Luke Froeb (Federal Trade Commission) before American Bar Association's Fall Forum, National Press Club, 529 14th Street, N.W., Washington, DC, 19 November 2003.

18 **Proposed acquisition by Tessenderlo Chemie SA of the Widnes Plant and business of Atofina UK Limited**, Director General's Advice, 24 July 2001.

4F The analysis of potential competition

4.18 In their present form, the guidelines only consider the issue of potential competition briefly (in contrast with both the US and EC merger guidelines, which consider the issue of potential competition in some depth). The CC notes in paragraph 3.29 of the guidelines that non-coordinated effects may arise in markets "*where the merger may involve a recent (or potential) entrant or a firm that provides a significant competitive threat to other firms in the market.*"

4.19 We consider that the utility of the guidelines would be enhanced by expanding the explanation of how the CC would assess whether a merger would lead to a loss of potential competition. Indeed, the CC can draw on its practical experience of assessing potential competition in various merger cases under the Act, including the following:

(a) **Bucher Industries/Johnston Sweepers**[19] - the CC considered a counterfactual of whether a relaunched Bucher would have imposed a significant competitive constraint on Johnston in the UK over the coming few years, absent the merger (see paragraphs 7.52 to 7.64);

(b) **H J Heinz/HP Foods**[20] – the CC considered whether the threat of potential entry of Heinz into the retail brown sauce market constrained the behaviour of HP in that market prior to the merger. The CC assessed whether Heinz was an actual potential competitor to HP (i.e. objectively likely to enter the market) or a perceived potential competitor to HP (i.e. being perceived as a potential competitor by HP). The report concluded that Heinz was one of a number of potential competitors to HP in the retail brown sauce market but did not on its own exercise a constraint on HP prior to the merger (see paragraphs 5.17 to 5.24); and

(c) **Stagecoach/Scottish Citylink**[21] – the CC considered both whether Scottish Citylink constrained Stagecoach as an actual potential competitor and whether Stagecoach constrained Scottish Citylink as a perceived potential competitor (see paragraphs 6.85 to 6.98).

4.20 The common themes in the analysis of potential competition in these cases suggest that the CC has a well developed internal methodology for assessing potential competition. Actual and perceived potential competition are assessed separately, before consideration is given to whether the potential competitor is in some way unique and whether there are a sufficient number of other potential competitors. We would encourage the CC to include a section in its revised guidelines that outlines its approach to potential competition, with examples and an indication of the type of evidence that would assist the CC in its analysis.

4G Coordinated effects

4.21 The CC has considered coordinated effects in several merger cases since the Act came into force. The assessment has rightly focused on the three conditions for coordination set out at paragraphs 3.37 to 3.39 of the guidelines, (i.e. the ability of participants to align their behaviour in the market, the incentive for firms to maintain coordinated behaviour and the sustainability of coordinated behaviour in the face of other competitive constraints in the market). Cases in which coordinated effects were a particular concern include:

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[19] **Bucher Industries AG / Johnston Sweepers Limited: A report on the acquisition by Bucher Industries AG of Johnston Sweepers Limited**, Competition Commission, September 2005.

[20] **H J Heinz and HP Foods: A report on the completed acquisition of the HP Foods companies by HJ Heinz Company and HJ Heinz Company Ltd**, Competition Commission, March 2006.

[21] **Stagecoach and Scottish Citylink: A report on the completed joint venture between Stagecoach Bus Holdings Limited and Braddell PLC in relation to magabus.com, Motorvator and Scottish Citylink**, Competition Commission, October 2006.

(a) **DS Smith/Linpac Containers**[22] – the CC did not find that all the necessary conditions for coordinated effects were present before the merger. Whilst the first two conditions for coordination (alignment and maintenance) may have been met, the third condition for coordination (sustainability) was not, as competitive constraints (especially the likelihood of new entry) were too strong;

(b) **James Budgett Sugars Ltd/Napier Brown Foods plc**[23] **–** the CC considered that the three conditions for coordination were met, but that the merger would not increase the likelihood of coordination; and

(c) **Wienerberger/Baggeridge Brick**[24] **–** the CC did not find evidence of coordination pre-merger. The first two conditions were found not to be met and the CC did not reach a conclusion on the third criteria.

4.22 We consider that the explanation of the three conditions for coordination could be expanded upon in the guidelines. We find the description of the conditions to be comparatively clearer in the OFT's merger guidance (see paragraphs 4.12 to 4.16).

4.23 We note that the CC's ex-post review of mergers highlights the importance of considering the three conditions for coordination, stating that in relation to the **Lloyds TSB/Abbey National**[25] merger, an explicit application of the guidelines may have led the CC to conclude that the conditions for coordination were met (see paragraphs 1.27, 3.38 and 3.40).

4H Barriers to entry and expansion

4.24 The treatment of barriers to expansion in the CC's current guidelines is relatively brief. In light of the fact that the assessment of barriers to expansion is often more important than the assessment of *de novo* entry in the analysis of merger cases, we would welcome an expansion of this section.

4.25 The CC's guidelines state at paragraph 3.51 that entry should occur within a timescale that "*is sufficient that it bears on the incentives and decisions of existing firms in the market*". The OFT guidelines are more specific about the time period, stating at paragraph 4.23 that "*entry within two years will generally be timely, but this must be assessed on a case by case basis*". We consider that having regard to the specific facts of the case when considering the relevant time period over which to consider entry prospects is of critical importance.

4.26 In its outline of factors to consider when assessing the potential for entry and expansion (paragraphs 3.56 and 3.57), the CC may wish to consider listing third party views as a relevant factor and explaining how these views are likely to be treated.

4.27 The guidelines presently note at paragraph 3.56 that the cost of gaining a significant share of the relevant market (usually 5 per cent) will be considered. The economic rationale for a 5 per cent figure is unclear and it would appear to be more useful to relate the size of the market share expected to be won by a significant new entrant to factors such as the minimum efficient scale of production, the critical level of sales that would need to be lost under a critical loss analysis and/or the size of the smaller of the parties to the merger. The extent of barriers to expansion that determine the ability of the entrant to win new business and expand further is also of relevance.

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[22] **Completed acquisition of Linpac Containers Ltd by DS Smith plc**, Competition Commission, October 2004.

[23] **Napier Brown Foods PLC of James Budgett Sugars Ltd**, Competition Commission, March 2005.

[24] **Anticipated acquisition by Wienerberger Finance Service BV of Baggeridge Brick plc**, Competition Commission, May 2007.

[25] **Lloyds TSB Group plc and Abbey National plc: A report on the proposed merger**, Competition Commission, July 2001.

4.28 Relating the size of any past market entrants to the estimated minimum efficient scale of production would enable the CC to determine whether such new entrants are likely to be efficient and therefore likely to exert a competitive constraint. Similarly, if a critical loss analysis reveals that a hypothetical monopolist would need to lose 40 per cent of sales in order to render a SSNIP unprofitable, a new entrant achieving a five per cent market share is unlikely to act, on its own, as a significant constraint on the leading firms in the market.

4.29 In addition, in situations of oligopolistic coordination, a small scale entrant may have a very large destabilising effect, because it has an incentive to win market share from its larger rivals, but little interest in the competitive status quo in which it receives a small share of industry profits.

4.30 The CC might also consider moving part of its section on the effect of a merger on entry and expansion, i.e. a theory of harm (see paragraphs 3.53 to 3.55 of the guidelines) to the section that considers the non-coordinated effects of a merger.

4I Failing firm

4.31 It would be helpful if the CC were to expand its current section on failing firms. In particular, we would suggest the following additions:

(a) a fuller description of the criteria that a firm must meet to be considered as "failing". The current guidelines only state that a firm must be unable to meet its financial obligations in the near future and that the firm should be unable to restructure itself successfully. In contrast to the OFT's guidelines, there is no description of the assessment of whether there is any less anti-competitive alternative to the merger.[26] Despite this, the CC did consider this third condition separately in its assessment of the **acquisition of GV Instruments Limited by Thermo Electron Manufacturing Limited**.[27]

(b) a description of the evidence that would assist the CC in assessing whether a firm is failing. The OFT merger guidelines state that it may request the following information to give weight to a failing firm defence[28]:

(i) that the company is indeed about to fail imminently under current ownership (including evidence that trading conditions performance are unlikely to improve);

(ii) that all refinancing options have been explored and exhausted;

(iii) that there are no other credible bidders in the market, and that all possible options have been explored; and

(iv) how the acquiring firm proposes to use the failing firm's assets post merger; and

(c) it would be helpful if the CC could explain the timescale within which a firm would have to fail in order to meet a failing firm defence.

4.32 We note that in addition to assessment of the merger between **Thermo Electron and GV Instruments**, the CC has considered failing firm arguments in a number of other merger

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[26] The CC's guidelines do state that consideration will be given to whether any other persons might have acquired the firm, its businesses or wish to do so.

[27] **A report on the acquisition of GV Instruments Limited by Thermo Electron Manufacturing Limited**, Competition Commission, May 2007. See Appendix F.

[28] See paragraph 4.39.

cases, including **acquisition by British Salt Ltd of New Cheshire Salt Works Ltd**[29] and the **Stagecoach and Scottish Citylink** case[30]. It would be helpful if the CC could illustrate its guidance with references to the analysis employed in such cases.

4J Vertical mergers

4.33 We consider that the current section on vertical mergers could be considerably expanded in light of the rich literature on the economics of vertical mergers. Whilst we agree with the CC's overall conclusion that a vertical merger will only raise competition concerns when the firms involved are able to exercise a substantial level of market power in one or more markets along the supply chain, the current guidelines do not reflect the complex economic issues that must be considered in assessing a vertical merger. In particular, we consider that the discussion of the possible theories of harm in vertical mergers would benefit from more detail and explanation. We note that the OFT's guidelines helpfully outline theories of harm relating to both upstream and downstream foreclosure and highlight the need to consider both the ability and incentive for the merger firm to foreclose in any market.[31]

4.34 Since the introduction of the Act, the CC has reached adverse findings in relation to the vertical merger situations arising out of the proposed **acquisition of the London Stock Exchange by Deutsche Börse AG or Euronext NV**[32] and also in relation to the completed **acquisition by Rail Investments Limited of Marcroft Holdings Limited**[33]. We do not consider that the current discussion of vertical mergers would have provided sufficient guidance to the parties to have understood the likelihood of an adverse finding in these cases – which is perhaps the litmus test of effective guidelines. We would suggest, moreover, that the framework of analysis which the CC used to assess these mergers could form the basis for a more detailed explanation of the CC's approach to vertical mergers, as well as providing an example of the theories in practice.

4.35 We would also suggest that the guidelines might mention two further potential issues that may arise from a vertical merger:

(a) where firms compete for scarce key raw materials via auction markets, the vertically integrated merged firm may gain a competitive advantage through its ownership of a business which sells an essential input via the auction. This can include, for example, "toe hold" effects, whereby the merged firm can bid higher prices than its competitors because if it wins the auction a proportion of the bid price will accrue back to the merged company through its ownership of the downstream firm. Advantages may also be gained through, for example, access to confidential information about the auction process. These issues were raised in the context of **BSkyB's bid for Manchester United**[34]; and

(b) vertical integration may enable a dominant supplier of a particular raw material to reduce the supplies available to the open market (by permitting its downstream

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[29] **A report on the acquisition by British Salt Ltd of New Cheshire Salt Works Ltd**, Competition Commission, November 2005.

[30] **Stagecoach and Scottish Citylink: A report on the completed joint venture between Stagecoach Bus Holdings Limited and Braddell PLC in relation to megabus.com, Motorvator and Scottish Citylink**, Competition Commission, October 2006.

[31] Paragraph 5.2.

[32] **Deutsche Börse AG, Euronext NV and London Stock Exchange plc: A report on the proposed acquisition of London Stock Exchange plc by Deutsche Börse AG or Euronext NV**, Competition Commission, November 2005.

[33] **Railway Investments Limited and Marcroft Holdings Limited: Completed acquisition by Railway Investments Limited of Marcroft Holdings Limited**, Competition Commission, September 2006.

[34] **British Sky Broadcasting Group plc and Manchester United plc: A report on the proposed merger**, Competition Commission, April 1999.

operation to purchase some of the raw material supply), with a view to raising the prices paid by independent customers and possibly facilitating price discrimination by reducing the scope for customers to engage in arbitrage. These types of issues were raised during the Commission's inquiry into the **Supply of Raw Milk** in 1999[35].

4.36 The CC should also make clear that countervailing factors, such as new entry and countervailing buyer power will be taken into account in the assessment of vertical mergers. Whilst this is standard practice in the assessment of vertical mergers, a short paragraph confirming this would nevertheless dispel any doubt.[36]

4.37 The CC notes at paragraph 3.67 of the guidelines that vertical mergers may change the conditions of competition such that coordinated effects are more likely. Whilst such an outcome is theoretically possible, it is unlikely in the vast majority of vertical mergers. Indeed, the existence of vertical integration can actually undermine the sustainability of collusion by hindering market transparency. This is because competitors of vertically integrated firms will be able to observe only the final product price and not any internal transfer price which might be lower than any tacitly "agreed" price for the semi-finished product. In addition, the vertically related firm might not buy any or much of its requirements from competing suppliers, and thus gain little knowledge of their prices. Moreover, whilst a supply relationship with competing suppliers might yield some knowledge of their prices, this would not reveal secret discounting by these suppliers to other customers. Finally, vertical integration might well impede coordination in other ways, such as by permitting various efficiencies to be achieved (thus creating a downward pressure on prices or improving quality), and/or otherwise lead to greater asymmetries in cost structures.

4.38 Ashurst suggests that the CC indicates that vertical integration will facilitate collusion only in rare cases, as the OFT already states in its merger guidelines.[37]

4K Conglomerate mergers

4.39 The guidelines currently focus on portfolio power and only make brief reference to tying and bundling. It would be helpful if the CC would explain how it would assess issues relating to tying and bundling. For example, competition authorities have, in several cases, assessed whether a merged entity would have the ability to engage in tying (often considering whether the merged entity has a "must have" product to tie other products to) and whether the merged entity would have the incentive to engage in tying.

4L Counterfactual

4.40 Aside from the discussion of failing firms, the CC's guidelines do not offer any further discussion of the counterfactual.[38] The issue of the appropriate counterfactual is a focal point of merger assessment and the guidelines need to be updated to reflect current practice on this point. As with other issues, the objective for the guidelines is to explain the CC's analytical approach to the issue in sufficient detail that the parties can make a reasonable prediction of the CC's likely assessment, and of the evidence which will best inform its conclusions.

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35 **Supply of Raw Milk: A report on the supply in Great Britain of raw cows' milk**, Competition Commission, July 1999.

36 This approach is taken in the OFT merger guidelines – see paragraph 5.6.

37 See paragraph 5.5 of the OFT merger guidelines.

38 We note that the OFT guidelines are a little more detailed, noting that likely and imminent changes to the regulatory structure of the market, such as market liberalisation, or tighter environmental constraints, can change the nature of competition (see paragraph 3.24).

4.41 In particular, we would welcome discussion in the guidelines of the issue of how to decide which of a number of possible counterfactuals is the most appropriate. Such a discussion can draw on the CC's experience of dealing with this issue in practice. For example, in considering the merger between **Serviced Dispense Equipment Limited and the Technical Services function of Coors Brewers Limited**[39], the CC considered several possible counterfactuals and ultimately decided to assess the impact of the merger by reference to the most favourable counterfactual. That said, we consider that in situations where there are a number of possible counterfactuals, the CC should conduct its analysis by reference to the *most likely* counterfactual rather than the most favourable. Such an approach not only means that the counterfactual offers the best approximation of the conditions of competition in the absence of the merger, but also offers an objective measure, whereas the issue of which counterfactual is most favourable is potentially subjective as the differing interests of the stakeholders in the investigation may mean than different counterfactuals are more favourable to different parties.

ASHURST LLP

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[39] **A report on the proposed acquisition by Serviced Dispense Equipment Limited of the Technical Services Function of Coors Brewers Limited**, Competition Commission, March 2005.