

The treatment of Repeated Acquisitions by the same purchaser in the same Market in the Merger Guidelines ‘CC2’

The first section of this note outlines the reasons why a change to the merger guidelines may be beneficial, and discusses some potential counter-arguments. The second section outlines a proposed adjustment. In the third section an alternative approach is outlined that may improve matters within the existing legal framework. The fourth section concludes.

Although this note is being submitted in response to the Competition Commission’s review of the merger guidelines, it may not be feasible to fully adopt the change proposed without amending the Enterprise Act (2002), and in particular section 27.

A significant lessening of competition due to the persistence of competition effects from past acquisitions

Acquisitions of firms with limited market share will not usually create a significant lessening of competition in the relevant economic market. The business motivation for acquiring these businesses can include overcoming significant barriers to entry such as acquiring important property rights (intellectual or physical) or key personnel. Such assets and the competition (market share) effects of acquiring them can persist for a significant period.

If a large firm acquires several small firms in the same market before any adverse concentration effects of previous mergers have been eroded through competition then, although each merger assessed individually will have a small (non-significant) effect on the intensity of competition, the combined effect of the treatment of such acquisitions by the competition authorities could be to allow a significant increase in market share, and thus a significant lessening of competition.

One example of where there is risk of such an occurrence would be in the convenience retailing sector. In this sector individual markets are very local and even in local markets the increase in market share from an acquisition by a large supermarket has usually been small. The small change in market share means that competition investigations are unlikely to find that the merger has resulted in a significant lessening of competition.

There have been cases where individual supermarkets have acquired two or three convenience store chains which operate in the same local market within a few months of each other.¹

A firm acquiring many smaller rivals may create just as many (or more) competition concerns as a firm acquiring a single large competitor. If the merger of two companies would create competition concerns this is true whether the combination is achieved in a single transaction or if several brands or sites are transferred consecutively to the acquiring firm. The economic effect of these two methods of transfer is similar, especially if the economic impact of the first asset transferred is

¹ Tesco acquired T&S Stores in 2003, and Adminstore in 2004. Sainsbury’s acquired Jacksons in 2002, J B Beaumont and Bells Stores in 2004 and SL Shaw in 2005. None of these transactions were referred to the CC.



still persistent in the market when the final acquisition occurs. Under section 27 of the Enterprise Act, the OFT has the discretion to treat successive transactions between the same parties within a two-year period as having occurred simultaneously on the date of the latest transaction. However, this is not the case for a single firm acquiring many smaller firms in the same market.

In terms of the HHI, an industry would be regarded as more concentrated (have a higher HHI) if several small firms were acquired at once than if a single large firm (with the same total market share) was acquired. The situation of repeated small acquisitions could have a larger impact on concentration and thus competition than the situation covered in the Act.

A potentially beneficial amendment to merger policy would be to consider not just the increase in market share from the current merger, but the total increase due to all the acquirer's previous acquisitions that continue to have a persistent effect in the same market. To ensure the system is not open to abuse, when a merger affects the same market as a previous acquisition the extent to which the market share increase allowed by the competition authorities has persisted could be considered before a further merger that may also damage competition is cleared.

The merger clearance test of a "significant lessening of competition" is supposed to prevent unwarranted interference in corporate deals when the analysis is uncertain, especially where the uncertainty is substantial. It may well be that a large merger that is considered to have small net costs could, in light of plausible future outcomes, actually be highly beneficial to society. However, this is less likely to hold for small mergers with small evaluated net costs. When such mergers affect the same markets as other previous mergers that have also imposed competition costs, the rationale for allowing such concentrations reduces substantially.

By giving more consideration to smaller mergers there is a risk that insignificant mergers take up too much regulatory effort. However, the mechanism used to guard against the danger of expending effort on insignificant transactions is the notification threshold. For transactions below this threshold the merging parties do not have to expend resources notifying authorities and waiting to see if an objection is raised, and the authorities do not have to examine the transaction. The later acquisitions will involve the same market and the same acquirer so there should be some synergies both for the authority and the notifying party where evidence or experience from previous analysis can be used. Thus the additional work required need not be out of proportion to the additional market share acquired.

It may be that, in light of considering the importance of repeated small transactions in the same market, it is later determined that the notification threshold should be revised. But it is not clear that a revision is required at this stage. One possibility is that lower limits could apply to acquisitions by the same firm. However, for practical reasons of clarity and simplicity of legislation it may be preferable to merely apply this test as an internal screen in the competition investigation.

Expending effort on a small acquisition may seem wasteful due to the limited potential effect on consumers, in particular because the barriers to entry for a small firm may be expected to be lower than for a large firm. However, if the barriers to entry were low the acquirer might be expected to start the business from scratch rather than paying a bid premium. Many small firms



can possess intellectual property protection or specialist assets, especially labour. In the convenience sector barriers may be less obvious but still significant: for example, the wholesale distribution costs, consumer loyalty, or availability of suitable sites, could all mean that convenience store chains cannot be quickly built up from scratch. Barriers to expansion appear to be more difficult to surmount than barriers to entry at the smallest scale.

A practical approach to assessing a significant effect on competition

The first key point to note is that no merger policy should be retrospective. Once a merger has been cleared then the clearance should stand and only future mergers (that require notification) should be referred (by the OFT) or blocked (by the CC), even if the later assessment considers the wider picture of other previous mergers in the sector. Any retrospective application would create significant uncertainty for firms. Retrospective action might discourage firms from introducing bundled products or adopting creative strategies to increase the performance of their acquisitions.

One way to determine which past acquisitions should be considered in an investigation would be to set a time limit on the period which would qualify, as laid down in section 27 of the Enterprise Act. However, determining an appropriate period to apply to all industries would be very difficult in light of the large variety of industries and the lifetime of brands (persistence of market share). For instance, some technological inventions are superseded within a couple of years, while other patents remain important constraints on the market for 20 years. Copyright for some music recordings is still bringing in revenue up to 50 years later, even though these may be owned by small record companies or individual artists (i.e. they are small firms protected by significant barriers to entry). The alternative is to examine how much of the market share acquired previously has continued to persist in the market.

Ideally the increase in market share that has persisted from all the acquiring firm's previous mergers in the sector should be established. Once the market definition has been determined, merger analysis usually proceeds to determining the current market shares of both the parties. The method outlined here is that the acquiring firm should be viewed as the larger of either (a) the market share of the acquirer when it made the first relevant acquisition in the market, or (b) the current market share of the acquiring firm minus the market share of any previous relevant acquisitions (evaluated on the dates they were acquired). The target firm is considered to be the remaining market share required to take the acquiring firm up to the actual market share once the current merger is completed.

Once a competition investigation finds that the effect of a merger no longer persists at all, then this merger can be ignored for all future investigations, and in practice it may be sensible to ignore previous mergers except where there is reason to believe that they are continuing to have an impact in a market or they were believed to harm competition (even if it was not at the time regarded as a significant lessening of competition and no proportionate remedy was imposed).

Thus the acquirer will be treated as acquiring all the previous acquisitions in one go, except that any of the increase in market share that has been competed away will be assumed to have reduced the importance of the previous mergers (up to the point where previous mergers no



longer have an effect). If, when a firm proposes a merger, its total market share is not greater than the market share when it acquired a previous firm or asset, then that previous transaction can be ignored because it no longer has any persistent effect. In assessing the latest acquisition the competition authorities cannot impose restrictions on any previous transaction.²

A numerical example

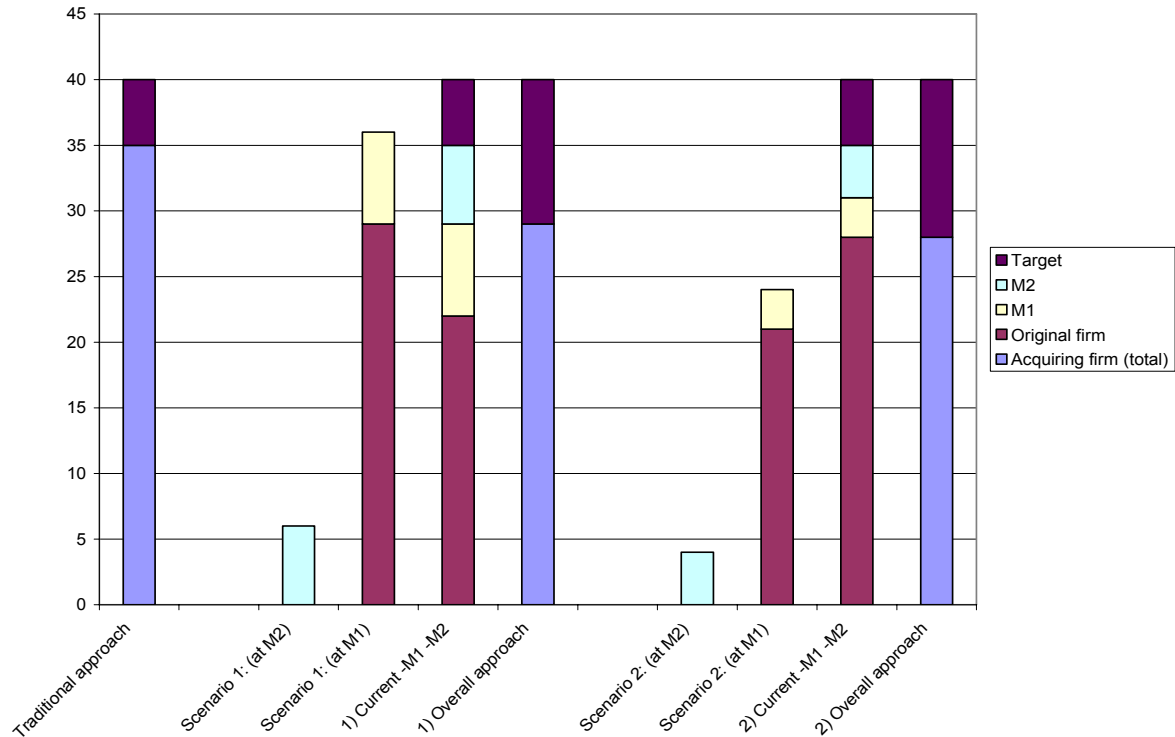
The illustration below shows a firm that has a market share of 35 per cent merging with a firm (the target) that has a market share of 5 per cent (issues of product and geographic market definition will have to be resolved before conducting this analysis). The acquiring firm consists of the original firm (the firm as it existed before two prior acquisitions) and two firms it has already acquired (M1 and M2). If we assume that both prior transactions had been previously notified to the competition authorities there would be records of any analysis conducted. Any of the three parts of the business, (the original firm, M1, or M2) can have increased their market shares since the date they 'joined' the firm (at M1 for the original firm and M1, and M2 later). In the analysis these three components are each measured at the size when they 'joined'. Two scenarios are considered: in the first the original firm has seen its market share fall due to external competition. In the second, all the increase in market share due to the past acquisitions has persisted.

(continued...)

² It would be possible to treat any market share gains of the acquired firms even more favourably by excluding those from the merger test (rather than using them to increase the likelihood of the effects persisting). This would take account of the fact that these improvements have been created from past mergers and would ensure the chance of a future merger being allowed was not reduced because of this type of success. However, any efficiency gains should be considered in a full merger investigation. If a previous acquisition in the same market has increased its market share, this may be evidence that the acquirer can create value for consumers from similar transactions to the one being considered. Different treatment of the market share gained by past acquisitions would risk under-reporting the merged firms influence on the market (for instance it is possible the increase was due to abusing market power), and would also greatly complicate assessment. In the method applied in this section gains by the acquired firms are not counted as part of the target.



The market shares of the merging firms when mergers took place and as considered in the proposed significant lessening of competition test for two scenarios



Scenario 1: The current market share of the acquirer is 35 per cent. If the market shares of the acquisitions at the date of previous mergers (7 per cent for M1, and 6 per cent for M2) are subtracted, the market share becomes 22 per cent. However, the firm originally had a market share of 29 per cent before any mergers, so that it appears the effect of previous mergers have not fully persisted. In this approach the market share of the acquirer should be considered to be 29 per cent and the remaining 11 per cent market share that would take it up to the actual level after the current (third) merger is considered the size of the target.

In this example the 11 per cent target that should be assumed happens to be exactly equal to the size of the M2 transaction plus the current target. Thus in the merger analysis the authorities can treat the acquirer as acquiring the last two firms simultaneously and deal with the specific products and overlaps that this would imply. The effects of the first merger M1 have been competed away and should not be considered in any later merger investigations. If the assets of a previous merger were later sold or there are clear signs the increase in market share has not persisted (with the acquirer's market share instead coming from the original business) then it may be appropriate to ignore that merger or reduce the market share ascribed to the past acquisition to just the share of the assets that were retained.

Scenario 2: Here the firm has been successful and grown over time. The size of the current firm net of the size of the two previous acquisitions (evaluated on the date they were acquired) is 28 per cent, which is larger than the previous (original) size of the firm at 21 per cent. The target firm in this method is thus the full size of the market share increase caused by the three acquisitions.



The total market share of the merged firm will be, as with the other scenario and current merger policy, 40 per cent.

Alternative approach: A significant lessening in competition from small mergers

Given the existing legislation it may be difficult for merger authorities to consider explicitly, and request further information on, past acquisitions, even if those mergers are only being used to assess the degree of competitive harm and will not be affected by any remedies. This is inconvenient because it is only when the relatively small harmful effects of small mergers are repeated that it is most sensible to take regulatory action to prevent the situation deteriorating. However, if competition authorities can efficiently evaluate mergers it may be possible to take more account of the possibility of smaller mergers having persistent negative impacts on competition within the current merger legislation and without requiring explicit consideration of past acquisitions.

The merger test should ideally look not at whether market competition in general is reduced by the transaction (and thus has a significant negative effect), but whether the transaction harms competition and efficiency (and is thus likely to be harmful). If the net effect of any change is likely to be harmful, that change should ideally be avoided even if it is small. The test for determining if a merger significantly lessens competition is based on the whole market and whether consumers in general are likely to be adversely affected, for instance, whether market prices are expected to rise (by e.g. 5 per cent). When the transaction is large relative to the market then this analysis, even leaving room for doubt, is sensible because there may be efficiencies (cost savings or demand-generating capabilities) that are created by the transaction and not taken fully into account in the analysis. For large acquisitions, unquantified synergies could potentially outweigh a small estimated increase in market prices and mean that the merger could be competition-enhancing in the medium to long term.

However, if the merger involves only a small fraction of the (local) market then there is less chance of error in an assessment that there will be a net cost to consumers. The adverse price effect may be large relative to the size of the transaction under consideration even if it is not significant relative to the market (e.g. does not cause a rise of 5 per cent overall). The prices paid by the customers of the acquired firm may be expected to rise significantly even if prices over the entire market do not (conditional on limited switching between sub-markets or suppliers). If further mergers of this type are allowed while the effects of the first merger persist the damage to competition will increase and could become significant in the market as a whole.

An adjustment to the merger test that would reduce the need to consider past mergers would be to evaluate mergers on the basis of whether the estimated costs (price rises) are significant compared to the size of the acquisition and the potential benefits. This would allow the decision of when a 'significant' lessening of competition is present to rest more formally on the probability that the competition authorities will have made a mistake in determining the merger to be anti-competitive. One method may be to scale the price increase required (e.g. an acquisition of a firm with 20 per cent market share by a firm with 30 per cent market share would need to raise market prices by 5 per cent to be anti-competitive, but if the acquired firm only had a 10 per cent market share the increase in overall market prices would only have to be 2.5 per cent for the



merger to be anti-competitive). Setting precise thresholds for assessments like this would be complicated.

A further problem with evaluating costs relative to market share changes is that it does not necessarily take into account the dynamics of market competition and may make it too difficult for a firm to make a key strategic acquisition with important synergies and new products or research. If the market has been correctly defined and is working effectively, with customers able to switch, then the analysis currently used will correctly find that competition is unlikely to be harmed by a small acquisition and the acquirer should be given the chance to make efficient use of the acquired resources based on the premium it is willing to pay. The concerns being raised still apply to any significant extent only when several acquisitions are made in a continuous expansion and market competition does not react swiftly enough to erode this impact.

The recent developments in the Competition Commission's grocery inquiry may provide another potential application for the ideas raised here. The proposed local competition test for grocery developments over 1,000 square metres, could take account of past acquisitions in the local area as well as the current retail provision. The consideration of repeated acquisitions may have greater relevance if the local competition test is revised to consider all grocery outlets in the vicinity of the proposed store including convenience stores.

Conclusion

There are reasons to believe that the competitive effects of a single firm acquiring many small firms can be as severe as a firm acquiring the same market share in a single transaction (and the increase in HHI can be greater). Concerns like these are accounted for in the special consideration of consecutive transactions between the same two parties. While a single transaction will be carefully reviewed, the effect of any particular small transaction may not be fully considered because it is thought to account for an insignificant part of the market. It is not clear that the transaction cost of reviewing these mergers are excessive, and some attention may be beneficial to prevent current legislation being abused by firms that make several acquisitions in the same market in quick succession.

Rather than imposing strict rules on the previous mergers that should be taken into account, it is helpful to review the extent to which the effects of past acquisitions have persisted. By taking account of the extent to which the current position of the acquirer is due to past mergers and not business success the significance of the change in competition from all the firm's acquisitions can be judged. The decision that competition is not significantly lessened should be evaluated by considering not only the merger most recently notified but also previous acquisitions that were considered not sufficiently harmful to competition to require remedy.

Adrian Proctor, Consultant, Europe Economics (www.europe-economics.com)