Oxera

Response to the Competition Commission consultation on the Merger Guidelines

April 4th 2008

1 Introduction

Oxera is delighted to have been provided with the opportunity to respond to the Competition Commission's consultation on amending its Guidelines for Merger References (the Guidelines). The Guidelines are an important element in ensuring that the CC is able to provide a reasonable degree of certainty to both businesses and competition practitioners as to the processes which will be adopted, and the factors which will be taken into account, when assessing mergers referred by the OFT for in-depth review. It is therefore important that the Guidelines are regularly updated to reflect best practice, and this consultation plays a crucial role in that updating process.

There are a number of areas in which amendments to the Guidelines could strengthen their ability to offer effective guidance for practitioners and businesses alike.

2 Market definition

2.1 Paragraph 2.2: Use of market definition

This paragraph sets out that market definition is a useful tool in assessing the likely impacts of a merger, which is the case under most circumstances. However, it could also be noted in this paragraph that, under certain circumstances, there may be scope to omit market definition altogether and focus on the direct effects of the merger. In recent years there has

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been something of a move towards unilateral effects analysis having greater weight in the process than previously, and there is scope to reflect this in the Guidelines.

An example of where this type of analysis was adopted is the *Volvo/Scania* case in front of the European Commission; the *Somerfield/Morrisons* merger also followed the same approach to a certain extent.[1] In these cases, there was a move away from the requirement of a precise market definition in order to determine market shares towards the use of consumer survey evidence and identification of the profit-maximising price increase following a merger.

2.2 Paragraph 2.5: Critical loss test

The CC defines the hypothetical monopolist test in terms of whether it is *profitable* to sustain a SSNIP. This differs from the formulation used in the US Horizontal Merger Guidelines, which refer to the question of whether a *profit-maximising* hypothetical monopolist would impose a SSNIP.[2] Not all practitioners are aware of this difference, and in many circumstances it will not make a great difference to market definition. Despite this, it would be helpful to practitioners if the CC Guidelines explicitly highlighted this difference with the US test (the tests in the guidance by the OFT and the European Commission are defined in a way that is similar to that of the CC[3]). In practice, the difference will matter when the CC and/or the parties involved carry out a critical loss analysis to apply the SSNIP test. Economic theory has identified two formulae to determine the critical loss (or critical elasticity)—ie, the break-even critical loss and the profit-maximising critical loss. The former is of relevance to the CC's formulation of the SSNIP test since it tests whether profits are higher or lower than before the price increase.

The break-even critical loss formula is $x/(x+m)$, where x is the postulated SSNIP and m is the pre-merger price–cost margin. As well as being consistent with the CC's formulation of the SSNIP test, the break-even critical loss formula has two significant advantages over the profit-maximising critical loss formula:

- it is more intuitively linked to the concept of critical loss in the first place—ie, the need to test the effect of a price increase on profitability;
- the formula does not depend on the shape of the demand curve, and hence does not require any potentially sensitive assumptions regarding the demand curve.

2.3 Paragraph 2.8: Size of SSNIP

Paragraph 2.8 of the Guidelines sets out the level of price increase that the CC states that it will adopt for the SSNIP test. It is currently stated that:

> the CC will normally use 5 per cent for the SSNIP test, rather than the more common 5 to 10 per cent, because in many instances an increase in the price of a product of around 5 per cent (with all other prices unchanged) might reasonably be judged to have

[1] Case M1672 of 23rd March 2000, and Somerfield plc /Wm Morrison Supermarkets plc: A Report on the Acquisition by Somerfield plc of 115 Stores from Wm Morrison Supermarkets plc: Final Report, published 02.09.05.

[2] See Section 1.0 of the 1997 DOJ/ FTC US Horizontal Merger Guidelines.

[3] See, for example, paragraph 17 of the Commission Notice on the definition of relevant market for the purposes of Community competition law.

> a significant effect on customers' expenditure on that product and so provides an appropriate level at which to consider the test.

The impact on consumers' budgets is indeed an important element in determining what level of price rise should be deemed to be 'small but significant'. This has been implicitly acknowledged by the Competition Commission in the groceries market investigation where, in paragraph 4.10 of the Provisional Findings paper, it is stated that the size of a SSNIP in the groceries market is likely to be less than 5%. However, further guidance on this area would be helpful as, at present, little detail is given in paragraph 2.8 of the Guidelines as to the circumstances in which the CC will deviate from a 5% SSNIP.

It would be an improvement to the Guidelines as currently drafted to shift the focus from a 5% 'point' estimate of a SSNIP to a range (which could be 5–10%, in line with other competition authorities, or could be slightly wider), and then to provide additional guidance regarding the factors that could lead the CC to consider a higher or lower point within that range. For example, a possible approach would be to state that a lower SSNIP will be chosen for consumer goods where the product produced by the merging parties makes up a higher proportion of the consumption basket of the average consumer. Similar considerations could apply in industrial mergers by examining the uses of the industrial product, and the proportion of costs of downstream producers that they represent. The adoption of a default 5% SSNIP may lead to a *de minimis* price rise in some markets where the product has a low price and therefore makes up a small proportion of the consumption basket of the average consumer. This may lead to the price increase not reaching the level at which it is considered significant by consumers. It is also notable that a smaller price increase generally tends to imply a stricter test to be passed (although the extent of this effect depends on the shape of the demand curve), and, as such, the CC is adopting a stricter approach than that taken by the OFT.

Furthermore, when using surveys to adduce stated-preference evidence for merger inquiries, there can be distinct advantages in using figures other than 5%. Other values may be easier for survey respondents to envisage (adding 10% to the price of a product generally being somewhat simpler than adding 5%); alternatively, using a figure other than 5% may simply make more sense in terms of pricing points (for example, for an item generally priced at £6.99, a price increase to £7.49 may be more logical and comprehensible than a price increase to £7.34).

Oxera concludes, therefore, that the Guidelines would be improved by a move to a 5–10% price increase representing a SSNIP, alongside guidance on what factors are likely to affect the size of SSNIP that the CC will consider appropriate.

2.4 Paragraphs 2.20 to 2.23: Supply-side substitution

Paragraph 2.22 states that:

> The CC will consider whether it is feasible to incorporate supply-side substitution into its calculation of the size of the market or whether it will calculate the size of the market based on the demand side only whilst incorporating in its assessment of the merger the fact that supply-side substitution imposes an effective competitive constraint on the incumbents.

However, this section does not set out the considerations that will be taken into account when determining which of these options will be chosen; nor, in the case of incorporating supply-side substitution at the competitive effects stage, whether and how there will be a difference between supply-side substitution and (potential) market entry.

2.5 Paragraphs 2.30 to 2.32: Chains of substitution

The Guidelines set out clearly a number of considerations regarding chains of substitution and their use in defining relevant markets. However, there may be advantages in providing a greater level of detail in this section. In particular, the Guidelines do not make it clear that, when considering chains of substitution, it is not the case that the hypothetical monopolist needs to be able to profitably raise prices in more than one product (for example, products A and B), but only in the focal market (for example, product A). Tesco was criticised by the CC in its Provisional Findings for the groceries market investigation for making an error of this type with regard to the simulation model of the groceries market.[4] In that case, Tesco had assumed that a hypothetical monopolist of groceries would raise prices equally at all of its stores, leading to an overly wide market definition.

3 Competitive effects of a merger

3.1 Paragraph 3.6: Choice of market share metric

The CC provides details on the methods by which it will calculate market shares in mergers. . It states that the choice of method (for example, using revenues, volumes, production capacities or inputs) will depend on the markets concerned and the information available.

More detail in this area would be valuable. In particular, there are valid theoretical reasons for choosing some metrics over others—for example, turnover is usually the best measure of current significance within a market, whereas capacity is of more relevance when supply-side substitution into the market is important. Furthermore, availability of information should rarely be the primary concern when determining market share metrics—with sufficient time for data acquisition and processing, the CC is likely to be able to obtain estimates of most metrics for most markets.

3.2 Paragraphs 3.7 to 3.10: Market shares and concentration

In paragraph 3.10 the CC sets out the thresholds which the OFT has adopted in terms of HHI levels for consideration of a merger, and states that it will 'have regard' to them, but only as a single factor within a wider assessment of competition.

The OFT's guidance states that concerns are unlikely to be identified where:[5]

- the post-merger HHI is between 1,000 and 1,800 and the increase in HHI resulting from the merger is less than 100; or
- the post-merger HHI is over 1,800, and the increase in HHI resulting from the merger is less than 50.

It is generally the case that consistency between the OFT and CC is helpful within the competition regime, to ensure that mergers which are potentially problematic are referred to the CC, and those that are not are dealt with by the OFT at phase 1. If the CC is tougher than the OFT, there is a risk that mergers which the CC would find may lead to a significant

[4] See paragraphs 4.126 to 4.141 of the Provisional Findings report.

[5] See paragraph 4.3 of OFT (2003), 'Mergers: Substantive Assessment Guidance'.

lessening of competition are not referred to phase 2. On the other hand, if the OFT is tougher than the CC, there may be cases referred for phase 2 investigation which the CC is unlikely to find problematic, leading to wasted time and resources on behalf of both the participants and the CC. As the CC has not set out any particular HHI levels and increments which it will consider as representing the minimum for competition concerns to be raised, both of these scenarios are possible, although it seems more likely that inconsistencies will relate to the OFT having wider 'safe havens' than the CC.

Strengthening the CC's commitments to HHI-related thresholds should not be unduly binding. The CC already sets out (paragraph 3.4) a threshold in terms of raw market shares. HHIs, and increments to them, provide considerably more information than such market shares, as they give a better reflection of the overall structure of the market, and of the effect that a merger is likely to have within it. In general, HHI thresholds are preferable to the thresholds set out in paragraph 3.4 for the purposes of considering the impact of a merger.

It may therefore be helpful for the CC to strengthen its commitment to the OFT's thresholds for merger assessment in order to reduce the probability of the OFT failing to refer mergers which the CC may find problematic under its current Guidelines. The likelihood of mergers which would significantly lessen competition being below these thresholds is relatively low.

3.3 Paragraphs 3.11 to 3.15: Other structural factors

Paragraph 3.13 provides a very brief comment on network externalities and their role in assessing mergers. However, the paragraph considers only one-sided network markets (those where each user increases the value of the product to other users), rather than two-sided network markets where there are two types of user (for example, merchants and cardholders in card payment systems, or advertisers and consumers looking for services in the classified telephone directory market). It is not made clear in this section whether network externalities will be considered the same way in one- and two-sided network markets.

Furthermore, paragraph 3.13 states that market shares and market concentration 'may not adequately convey the degree of competition in the market'. However, no indications are given of what factors, if any, will replace market shares and market concentration in the CC's analysis of a merger.

3.4 Paragraphs 3.22 to 3.25: Impact on rivalry of horizontal mergers

Paragraph 3.25 considers the possibility that a merger may lead to the merged firm having market power over its suppliers, without such buyer power merely offsetting upstream (producer) market power, and states that there could be 'excessive' buyer power, even in situations where there is no impact on consumers (as there is no market power in downstream markets). It is not clear what the CC is envisaging here—although a theory of harm based on buyer power has been put to the CC in the groceries market investigation, no evidence has been found of a waterbed effect. Anti-competitive buyer power is a complex topic, with little precedent, and more guidance in this area would be helpful.

3.5 Paragraphs 3.26 and 3.27: Efficiencies

It is notable that the Guidelines do not match the OFT's policies, as set out at paragraphs 4.29 to 4.31 of the OFT's Substantive Merger Assessment Guidance. The particular difference arises in paragraph 3.27 of the CC's Guidelines, which states that 'the efficiencies [must] increase rivalry among the remaining firms in the market'. This seems to eliminate the possibility of using the effect referred to in paragraph 4.31 of the OFT's guidelines, which

states that ’if a merger would reduce rivalry in a market, but proven efficiencies would be likely to lead to lower prices to customers, [this] might be a consideration under the customer benefits exception to the duty to refer.

In general, it appears that the CC’s approach, as set out in the Guidelines, would not fulfil an aim of maximising consumer benefits (nor, indeed, of maximising overall societal welfare). A merger that results in (sustained) lower prices should be beneficial for consumers, regardless of whether it increases rivalry between firms (and even if it results in a reduction of rivalry). The critical factors are that the claimed efficiencies should be verifiable; should be contingent on the merger; and should result in lower prices to consumers. A combination of these factors is likely to be sufficient to generate increases in consumer welfare. Of course, there is a risk in some cases that, without increased (or at least not reduced) rivalry, such efficiencies will not be passed through to consumers; however, if it can be demonstrated that they will be, such mergers are welfare-enhancing and this should be taken into account.

4 Other issues

There are a number of other areas which can be important in the assessment of mergers, but which are not currently considered in the Guidelines. Two areas of particular importance are:

– the role of bidding markets in the assessment of mergers, and how the CC will look at mergers involving markets with bidding characteristics;

– the role of financial analysis and profitability assessment in the CC’s consideration of mergers. This could encompass the use of financial analysis to determine the pre-merger level of competition in a market, and profitability assessment to analyse pricing incentives after the merger.

These areas are of particular concern because they regularly arise in competition cases. For example, the recent *Travelport/Worldspan* merger considered the issue of two-sided markets, while bidding market characteristics were discussed in the context of the *GE/Honeywell* merger.[6] Guidance on these issues would be helpful.

5 Conclusion

Oxera hopes that these comments on potential amendments to the Guidelines are helpful to the CC. Our review of the Guidelines would suggest that a process of minor improvements and refinements would be beneficial.

[6] Case 2220 of 3rd July 2001 and Case 4523 of 23rd March 2007.