



# **Merger References: Competition Commission Guidelines**

Consultation Document

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# MERGER REFERENCES: COMPETITION COMMISSION GUIDELINES

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## **Part 1: Introduction**

### **Purpose of Guidance**

- 1.1 This guidance forms part of the advice and information published by the Competition Commission (the Commission) under clause 103(3) of the Enterprise Act (the Act). It explains how the Commission intends to address the questions to be answered in respect of merger references made to it under clauses 21 or 32 of the Act.
- 1.2 A list of other advice and information and other publications of the Commission and the Office of Fair Trading (OFT) relevant to merger inquiries can be found at [to be added in final version].
- 1.3 This guidance reflects the views of the Commission at the time of publication. Markets, economic theory and best practice evolve. This guidance may be revised from time to time to reflect such change or in the light of the Commission's experience in applying the new merger regime and new guidance may be published.
- 1.4 In addressing the questions the Commission<sup>1</sup> must consider in respect of references made under clauses 21 or 32, a group will have regard to this guidance and will apply such of the methodology and analysis summarised in it as it considers appropriate. However, the Commission will consider each reference with due regard to the particular circumstances of each case, including the information that is available and the time constraints applicable

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<sup>1</sup>In respect of each reference a group is appointed to carry out the Commission's functions. For further information about the appointment of groups and the procedures that apply see General Advice and Information and the Commission's Rules of Procedure.

to the case.<sup>2</sup> Accordingly the Commission will apply the approach described in this guidance flexibly and may, if it considers it appropriate to do so, depart from the approach described in this guidance.

### **Newspaper references**

1.5 Generally, references to the Commission concerning the transfer of a newspaper or of newspaper assets are made by the Secretary of State under the Fair Trading Act 1973. In those cases, the Commission must consider the merger against a public interest test and report its findings and recommendations to the Secretary of State. This guidance does not apply to such references.<sup>3</sup>

### **Water mergers**

1.6 The OFT has a duty to refer mergers between two or more water enterprises under section 32 of the Water Industry Act 1991 unless neither the value of the turnover of the water enterprises being taken over nor of each of the water enterprise belonging to the person making the take over does not exceed £10m. In these cases the questions to be decided by the Commission are different to those referred to in this guidance.<sup>4</sup> This guidance does not apply to such references.

### **The general merger questions**

1.7 A completed merger may be referred to the Commission under clause 21 of the Act and an anticipated merger under clause 32. The questions the Commission has to answer in respect of completed mergers are:<sup>5</sup>

*“(a) whether a relevant merger situation has been created; and*

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<sup>2</sup>For further information about the statutory period and the circumstances in which the inquiry may be extended see General Advice and Information.

<sup>3</sup>For more information about newspaper merger regime see sections 57 to 62 Fair Trading Act 1973 and clause 66 of the Enterprise Bill.

<sup>4</sup>For more information about the special water merger regime, including the meaning of “water enterprises” see sections 32 to 35 and Schedule 4ZA of the Water Industry Act 1991.

<sup>5</sup>Clauses 34 (1), (2) and (3).

- (b) if so, whether the creation of that situation has resulted, or may be expected to result, in a substantial lessening of competition within any market or markets in the United Kingdom for goods or services;*
- (c) whether action should be taken by [the Commission]...for the purpose of remedying, mitigating or preventing the substantial lessening of competition concerned or any adverse effect which has resulted from, or may be expected to result from, the substantial lessening of competition;*
- (d) whether [the Commission] should recommend the taking of action by others for the purpose of remedying, mitigating or preventing the substantial lessening of competition concerned or any adverse effect which has resulted from, or may be expected to result from, the substantial lessening of competition, and*
- (e) in either case, if action should be taken, what action should be taken and what is to be remedied, mitigated or prevented.”*

1.8 In respect of anticipated mergers the Commission has to consider similar questions. Of these, the first two questions are:<sup>6</sup>

- “(a) whether arrangements are in progress or in contemplation which, if carried into effect, will result in the creation of a relevant merger situation; and*
- (b) if so, whether the creation of that situation may be expected to result in a substantial lessening of competition within any market or markets in the United Kingdom for goods or services.”*

If the Commission decides that there is an anti-competitive outcome, it must then decide three further questions concerning remedial action similar to the final three questions for completed mergers.

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<sup>6</sup>Clause 35(1).

1.9 The first question, about a relevant merger situation, set out in paragraphs 1.7(a) and 1.8(a), will be decided before the second question, set out in paragraphs 1.7(b) and 1.8(b), which describes the test of whether there is a substantial lessening of competition (SLC). If the Commission decides after answering those two questions that there is an anti-competitive outcome, it will consider the remedies questions set out in paragraphs 1.7 (c) to (e). The factors the Commission will take into account are described in Part 1 of this guidance in respect of a relevant merger situation, Part 2 in respect of the SLC test, Part 3 in respect of the assessment of the competitive effects of the merger, and Part 4 in respect of remedies. The relevance of these factors to references made by the Secretary of State because she believes that a public interest consideration or special merger situation has arisen is discussed in Part 5.

### **Relevant merger situation**

1.10 The Commission has to decide first, in the case of completed mergers, whether a relevant merger situation has been created or, in the case of anticipated mergers, whether arrangements will result in the creation of a relevant merger situation.

1.11 The Act provides that a ‘relevant merger situation’<sup>7</sup> has been created:

- if two or more enterprises<sup>8</sup> ceased to be distinct not more than four months before the day the reference is made to the Commission; or
- if two or more enterprises ceased to be distinct and **no** notice of material facts about the arrangements or transactions in consequence of which the enterprises ceased to be distinct had been given as prescribed by the Act<sup>9</sup>; and

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<sup>7</sup>Clause 22.

<sup>8</sup>“Enterprises” is defined by clause 124(1) as “the activities, or part of the activities, of a business”.

<sup>9</sup>Clause 23.

- at least one of the turnover or share of supply tests is met as described below.

### *Enterprises ceasing to be distinct*

1.12 Any two enterprises cease to be distinct if they are brought under common ownership or common control (whether or not the business to which either of them formerly belonged continues to be carried on under the same or different ownership or control). Clauses 25 and 26 describe the circumstances in which enterprises must be treated as being under common control, when a person or group of persons may be treated as bringing an enterprise under his or their control, and how the time when enterprises cease to be distinct is decided when control is transferred by stages.

1.13 The **turnover test** will be met if the value of the turnover in the United Kingdom of the enterprises being taken over exceeds £45 million. This is calculated by aggregating the total value of the turnover in the United Kingdom of the enterprises which cease to be distinct and deducting:<sup>10</sup>

- (a) the turnover in the United Kingdom of any enterprise which continues to be carried on under the same ownership or control; or,
- (b) if no enterprise continues to be carried on under the same ownership and control, the turnover in the United Kingdom which, of all the turnovers concerned, is the turnover of the highest value.

1.14 The **share of supply test** applies to the supplies of goods or services of any description. If, as a result of the merger, the enterprises ceasing to be distinct either supply or are supplied at least one-quarter of all the goods or services of that description in the UK or a substantial part of it, the test will be met.

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<sup>10</sup>See also SI [number] Turnover threshold—general mergers.

1.15 The application of this share of supply test is different from the analysis that is undertaken when the relevant market is defined. The aim is to ascertain whether the Commission has jurisdiction enabling it to apply the substantial lessening of competition test. When applying the share of supply test, the Commission is able to apply such criterion or combination of criteria as it considers appropriate. For example, it could apply the test on the basis of value, cost, quantity, capacity or number of workers employed. Which criteria the Commission chooses will depend upon the circumstances of the case, though generally the Commission will have regard to the value of the goods, taking into account any rebates or discounts offered. The Commission is able to apply such criteria as it considers appropriate when deciding whether to treat goods or services as being of a separate description. It also has discretion as to whether to treat goods or services that are supplied differently as being of the same description or of one or more descriptions.

## **Part 2: Substantial lessening of competition test**

2.1 When the Commission has decided that there is a relevant merger situation it must consider whether the merger results in, or may be expected to result in, a SLC.<sup>11</sup> When doing so it will not be sufficient for the Commission to believe that a SLC is possible: for the Commission to reach an adverse decision either the merger must have resulted in a SLC or the Commission must expect such a result. It will usually have such an expectation if it considers that it is more likely than not that the SLC will result.

2.2 The Commission sees competition as a process of rivalry between firms or other suppliers (hereafter referred to as firms) seeking to win customers' business over time.<sup>12</sup> This rivalry may occur in a variety of ways. In some cases the emphasis will be on achieving the lowest level of costs and prices in order to undercut competitors. In other cases, firms may go well beyond this, using entrepreneurial and innovative skills to develop new products and services, exploit particular strengths, abilities or other advantages held by a firm and, by these means, meeting consumer needs more effectively than competitors. Where these factors are important, competition will often be characterised by uncertainty, turbulence and change. Amongst other things, therefore, this process of rivalry may be illustrated by changes in market structure, the pattern of pricing over time or the extent of product innovation, for example. Whatever the process of rivalry the Commission will consider its effects over time and how it may be expected to develop. Rivalry has numerous beneficial effects: prices and costs are driven down, and innovation and productivity increase, so increasing the range, quality and, perhaps, the

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<sup>11</sup> See Part 5 concerning merger references made by the Secretary of State pursuant to clauses 44 and 61.

<sup>12</sup> <sup>12</sup>Other producers from which firms face competition need not be simply other commercial firms but might include government for example.

diversity of choice available to customers. Further, markets that are competitive generate feedback from customers to firms who, in consequence, direct priorities for innovation. In addition firms are encouraged to meet the existing and future needs of customers as effectively and efficiently as possible. It is where this process is dampened by a merger that competition may be substantially lessened. The degree of rivalry between firms or other producers for customer business and the threat of entry faced by incumbents are the main competitive constraints on firms, although other constraints such as buyer power may also, in some cases, be significant.

- 2.3 In applying the SLC test, the Commission will evaluate the competitive constraints on firms with the merger compared to the situation that would have been expected to prevail without the merger. The Commission's focus is on the effects that the merger has on competition. In this sense, competition concerns that do not result from the merger under consideration are outside the Commission's focus. They may, however, be matters which it is appropriate to consider in other ways, for example in a market investigation under the Enterprise Act<sup>13</sup> or against the two prohibitions of the Competition Act 1998. Such investigations might follow a merger reference.
- 2.4 The Commission's approach to assessing whether a merger results in, or may be expected to result in, a SLC<sup>14</sup> can be considered as a two-stage process. First the relevant market or markets for the goods or services concerned (hereafter referred to as products) are defined. Then the Commission assesses whether the merger would increase the market power of firms in the market so defined. Market power may be described most simply as the ability to raise price consistently and profitably above competitive levels (or where a buyer has market power, the ability to obtain prices lower than their competitive levels). In the case of horizontal mergers (ie mergers between firms operating

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<sup>13</sup>For information on market investigations see market guidelines.

at the same stage of the supply chain), for instance, this might occur through the elimination of an effective source of competition thereby weakening the rivalry among the players left in the market after the merger. However, firms with market power may simply opt not to compete as aggressively as they otherwise might, and, in so doing, allow costs to rise, reduce quality, restrict the diversity of choice and/or slow the rate of innovation. This is not to suggest, however, that a merger will always give rise to a SLC. For example, in some circumstances, a merger may enhance competition, particularly if it strengthens firms whose challenge to market leaders would be weak in the absence of the merger.

- 2.5 In assessing whether the structural change brought about by a merger is likely to lead to a SLC, the Commission will consider how effective remaining firms are as a constraint on the merged firm and whether there are any other competitive constraints that might be expected to impinge on the merged firm.

### **Market definition**

- 2.6 An important first step in deciding whether a merger results in a SLC is to define the relevant market or markets. There are normally two dimensions to the definition of a market: a product dimension and a geographical dimension. The products that should be included in the relevant market, and the geographic boundaries of that market, are determined by the extent to which customers can readily switch between substitute products, or suppliers can readily switch their facilities between the supply of alternative products. The key to market definition is substitutability.

- 2.7 The Commission does not regard market definition as an end in itself, but rather as a framework within which to analyse the effects of a merger on competition. The definition of the relevant market is a useful tool for

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<sup>14</sup>From now on in the guidance we use 'results' to include 'or may be expected to result'.

analysing the competitive constraints faced by the parties to the merger from other firms supplying the market. There is inevitably an element of judgement in defining the market and the Commission will adopt the methodology most appropriate in the context of the relevant merger. However, the generally accepted conceptual approach to market definition, used in many jurisdictions, is the SSNIP test (also known as the hypothetical monopolist test). The Commission will adopt this approach wherever it is feasible to do so.

- 2.8 The next section looks at how the SSNIP test might be used when considering the product market. In doing so it comments on the importance of both demand-side and supply-side substitution. It then explains how the SSNIP test might be used when defining the geographic market before considering some other aspects related to market definition, for example temporal markets and chains of substitution.

### ***SSNIP test***

#### *Product Market*

- 2.9 In using the concept of the SSNIP test for product market definition the Commission will consider whether a hypothetical monopolist of a certain set of products, which might constitute a market, could profitably impose a small but significant non-transitory increase in price (SSNIP). The principle behind the test is that a market is defined as a collection of products the supply of which can, hypothetically, be monopolised. The first stage of the test is to analyse the characteristics of the product including its intended use in order to establish possible substitutes that might be included in the relevant market definition. The second stage examines what happens when the relative price of these apparently substitutable products increase.
- 2.10 The application of the SSNIP test is an iterative process. In the case of a merger, the test typically starts by considering the narrowest group of

overlapping products that are produced by each of the parties to the merger. The following question is then asked: if there were only one supplier of these products (a hypothetical monopolist), would it be able to sustain a SSNIP profitably? If the price rise is unprofitable, then the closest substitutes are added to the group of products and the procedure is repeated. The relevant product market is defined as the smallest group of products for which a hypothetical monopolist could sustain a SSNIP profitably.

2.11 The SSNIP test is usually conceptualised by assuming a price increase for the group of products in question in the range 5-10 per cent, whilst assuming all other prices remain unchanged. The absolute size of the price rise used will depend on the circumstances of the merger, but in general the Commission's practice will be to hypothesise an increase of around 5 per cent, whilst assuming all other prices remain unchanged, to last for at least a year. In many instances, an increase in the price of a product of around 5 per cent (with all other prices unchanged) might reasonably be expected to make customers reconsider their purchasing decision and so provide an effective level at which to consider the test. A 5 per cent increase in price might also be expected to have an appreciable effect on a firm's profit margin, the main issue then being whether demand would be reduced to such an extent as to offset the effects of the higher margin.

2.12 One difficulty in considering the SSNIP test is that the existing price may be significantly above, or below, the price level that would result from a fully competitive market. For example, where a market has been to some extent monopolised, prices are likely to be above competitive levels. In the extreme case, prices will have been raised to the level at which a further price rise would lead purchasers to stop buying, or switch to alternatives that would not otherwise have been regarded as reasonable substitutes. Therefore, using the prevailing price level could lead to a market definition that is broader than the true market. This is because a further price rise might well be unprofitable,

and the SSNIP test might therefore suggest that other products should be included in the resulting product market even though they would not have been seen as substitutes had the competitive price level been used as the starting point for the test. This problem is generally known as the “cellophane fallacy” after the Du Pont case in the US.<sup>15</sup> The problem for the Commission is that at the outset of an inquiry it is unlikely to be in a position to be able to judge decisively whether the existing price level is competitive or not, or indeed whether the prices of possible substitutes are at the competitive level or not. Therefore, in practice, the Commission will use existing prices in its initial consideration of market definition for merger investigations. However, where the Commission’s subsequent understanding of the market leads it to believe that prices are substantially above the competitive level, the Commission recognises that prices more indicative of the competitive level might be more appropriate in its analysis of market definition.<sup>16</sup>

2.13 The overall effect of the SSNIP on profit will depend on the net effect of three factors:

- the decline in the quantity sold as customers switch to other products and/or producers of other products switch production;

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<sup>15</sup>US v El Du Pont de Nemours & Co, [1956] 351 US 377.

<sup>16</sup>Which of the price levels the Commission will use, if they give different market definitions, will depend on its assessment of which of two situations applies. Suppose that at a competitive price level, product A is in a different market from products B and C, but tacit collusion (see paragraphs 3.26 to 3.32) between B and C has raised their prices to the point where A becomes a substitute, so that the SSNIP test at current prices places all three products in the same market. In considering a merger of firms producing B and C, the Commission would tend to rely on the SSNIP test at competitive price levels; otherwise a merger which might increase market power could appear benign simply because the firms concerned had already been able to exercise a degree of market power. Although, necessarily in this example, the existence of product A would prevent more than a 5 per cent price increase, the merger would eliminate rivalry between the similar products B and C. However, in considering a merger between a firm producing C and another producing either A or B, the Commission would tend to rely on the SSNIP test at current levels. The test at a competitive price level would place C in a different market from its proposed merger partner, which would obscure the fact that the removal of C as a constraint on A or B could result in a SLC.

- any change in the costs of production, as the quantity produced decreases, and;
- the margin earned on each unit sold.

2.14 In order to measure the second and third of these effects effectively the Commission would need information on actual costs and margins and how they change with the amount produced. The first effect, substitution, is often a key focus of the Commission's analysis of market definition and is considered below.

2.15 The effect of customers switching to substitute products following a SSNIP is called demand-side substitution and is considered in the following section. The effect of suppliers commencing or increasing the supply of the products whose price rises following a SSNIP is called supply-side substitution. New suppliers commencing production (of the products whose price rises) might be considered, in some instances, as new entry and the distinction between supply-side substitution and new entry is considered after the section on demand-side substitution.

- *Demand-side substitution*

2.16 Demand-side substitution occurs because an increase in price makes a product less attractive to customers, who therefore decide to purchase less of it and more of substitute products. A formal measure of demand-side substitutability, known as elasticity, looks at the responsiveness of demand to changes in price, with all other prices remaining unchanged. Own-price elasticity measures the responsiveness of the demand for a product to a change in its own price; cross-price elasticity measures the responsiveness of

demand for a product to a change in the price of a different product.<sup>17</sup> Such measures may be considered when defining the market.

2.17 It is generally not possible, in the context of a merger inquiry, to apply the SSNIP test in any direct sense, that is to say actually observing a 5 per cent price increase across the products concerned and identifying what the consequence is for demand and for the profitability of the products concerned. Given this, it is usually necessary for the Commission to infer, from whatever information is available or can be collected, what the likely outcome of the SSNIP test would be. This can then be used to determine market definition.

2.18 Types of information that can be useful in assessing the degree of substitutability include:

- product characteristics such as physical properties and including intended use;
- responses from customers, competitors and interested and informed third parties to questions about customer behaviour and the SSNIP test;
- information enabling the estimation of “switching costs” that customers might incur in changing from the product of one supplier to that of another. These may be monetary or non-monetary, eg the time, effort, uncertainty etc involved in switching suppliers;
- information from the main parties and third parties used (or that could be used) to make past and future business decisions. This may include documents such as marketing studies, consumer surveys, market

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<sup>17</sup>An own-price elasticity of -1 means that a 5 per cent increase in the price of the product results in a 5 per cent decrease in the quantity sold of that product. Demand is said to be elastic when the own-price elasticity is greater than one (ignoring for the purpose of exposition the negative sign) and inelastic when the elasticity is less than one. Similarly a cross-price elasticity of +1 means that a 5 per cent increase in the price of product A results in a 5 per cent increase in the quantity sold of product B. For substitutes we would expect a positive cross-price elasticity (as an increase in the

analyses prepared for investors, and internal business analyses (eg board papers, business plans and strategy documents). The Commission might also consider any similar types of studies that have been prepared specifically for the inquiry;

- available information on the extent to which variations in price differentials through time have occurred, and their impact on trends in sales;
- estimates of own-price, and cross-price, elasticities of demand, for example from econometric studies, sales data etc;

In some cases it may be useful or necessary to supplement these with two other types of calculation:

- estimates of the sales that must be lost before a given price increase would be unprofitable (referred to as ‘critical loss’);
- estimates of the maximum own-price elasticity of demand that would still make an increase in price profitable (referred to as ‘critical elasticity’).

This may enable the Commission to judge how likely it is that a SSNIP would be profitable.

2.19 Various types of evidence on the responsiveness of customers to price changes may therefore be available to the Commission. Econometric estimates can provide information on elasticities, but their value depends on the robustness of the economic models used and the quality of the underlying data. Any econometric estimates submitted to the Commission should be supplemented by the full data set used, as well as a detailed description of each of the steps taken in the course of the estimation. This will help the Commission to understand fully the methodology used and allow it to replicate and assess the results. In merger cases, information may be limited and market surveys of various kinds are often used to provide information on the responsiveness of customers to price changes, sometimes, formally as

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price of one good leads consumers to substitute to the alternative good). For complements we would

estimates of demand elasticities. Surveys usually take the form of questionnaires to customers, competitors and interested and informed third parties. Any survey evidence submitted to the Commission should be supplemented by the complete survey results, as well as a detailed description of the methodology used.

- *Supply-side substitution*

2.20 In defining the product market, the Commission will give due consideration to supply-side substitution, which occurs when a price rise prompts other firms to start supplying, at short notice, an effective substitute to the product in question. Supply-side substitution will usually come from firms with existing facilities, providing similar products and/or operating in adjacent areas. Imports might be another source of supply-side substitution.

2.21 It is not always straightforward to distinguish supply-side substitution from potential new entry. The difference is typically one of timing and/or investment: supply-side substitution occurs in the short run with little or no investment required, whereas new entry is likely to occur over a longer period and may require more significant investment. Therefore, in order to consider a competitor's response as supply-side substitution, the Commission will want to be sure that any response is likely to occur within a year of the price rise (although the exact time period will depend on the nature of the market considered) and that it does not involve significant investment in plant, equipment, skills or training.

2.22 While the Commission will usually consider the extent to which supply-side substitution acts as a possible competitive constraint, and hence should be taken into account in defining the market, and will normally attempt to adjust market shares accordingly, it may not always be practicable to do so. The

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expect a negative cross-price elasticity.

Commission 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.

2.23 The following are examples of the types of information that can be useful, when available, in the analysis of supply-side substitution:

- information on past supply-side substitution;
- information on the willingness of customers to switch to new suppliers following a SSNIP;
- information on the size of adjustment costs<sup>18</sup> for potential suppliers;
- the business plans of potential suppliers and the assessment of their competitive threat by firms in the market;
- assessment by independent technical consultants and interested third parties of the likelihood and feasibility of supply-side substitution; and
- information on supply-side substitution in similar markets in other countries.

#### *Geographic market*

2.24 The SSNIP test, including both demand and supply-side substitution is also considered when defining the geographic market over which the merging firms supply. The geographic market may be international, national, regional or limited to certain localities.

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<sup>18</sup>Adjustment costs are those costs incurred in adjusting to the supply of the new product. For instance, they might include the costs of altering the production process or establishing the distribution of the product.

2.25 In considering the geographic market, the test looks at whether a SSNIP of the products in the relevant product market in a narrowly defined region would be profitable. If a SSNIP would not be profitable, for instance because customers switch to products in neighbouring areas, then these areas are added to the market and the procedure is repeated. The relevant market is defined as the smallest area in which a hypothetical monopolist could sustain a SSNIP profitably.

2.26 Similar information to that used to identify substitution in the product market can be used to assess the geographical boundaries of the market. In particular the Commission might consider the following:

- the cost to customers of switching to products supplied in other geographic areas and the cost to suppliers of supplying products to different areas (eg transport costs) in relation to the value of the products and the length of time taken to make the switch;
- product characteristics such as perishability;
- information on variation in prices and sales by area; and,
- information on flows of goods between regions or into the UK.

2.27 The potential competitive impact of imports can also be analysed in the consideration of the geographic market, in the same way as that of UK-based suppliers or potential entrants. Where a proportion of purchases within the UK is accounted for by imports, the Commission will consider whether customers would increase their purchases from overseas suppliers consequent upon an increase in domestic producers' prices and hence that the market is wider than the UK. In some cases, however, there may be obstacles to customers purchasing more from overseas, or to overseas producers increasing their UK supply, for example, trade barriers, national standards, regulations or just capacity constraints. Furthermore, imports controlled in any way by the parties to the merger—or perhaps other firms in the industry—are unlikely to be a source of competitive challenge to participants in the market. Even when imports account for a small proportion of UK consumption, it might be relatively easy for the proportion to increase in response to a SSNIP, and the Commission will need to consider this as a possible outcome of the SSNIP test.

*Other aspects relevant to market definition*

2.28 The Commission recognises the methodological and practical difficulties in delineating markets. These can be particularly acute in markets subject to rapid change, for example, in markets driven by new technology or in markets with other distinctive characteristics such as “bidding markets” where suppliers bid for the right to supply customers. This section looks at such factors and some other issues, such as chains of substitution, which are of relevance to market definition.

2.29 Some markets, such as bidding markets, are not characterised by usual market attributes. For instance, bidding markets tend not to have multiple buyers and multiple sellers over a continuous time period; competition for contracts occurs at particular times only. Applying the SSNIP test in this instance might lead the Commission to consider each contract as a market in itself. This may not, however, be very helpful in understanding the dimensions of

the market within which rivalry between firms occurs. In circumstances where the usual method of defining markets does not work effectively it will be necessary to consider other factors to help inform on market definition. For instance, information on the firms bidding for contracts and how they bid might be considered. Similarly when assessing competition in the market it may also be necessary to consider other factors. For instance, information on the track record of firms in bidding for contracts may be more indicative of the significance of firms in the market than other measures such as market share which might be difficult to calculate and perhaps misleading in such markets.

- *Temporal markets*

2.30 In certain markets, time is a factor that needs to be taken into account for the purpose of market definition. Time-related characteristics include seasonality, peak and off-peak services. When customers are not able to substitute products between periods, a temporal dimension may be added to the market definition. A typical example is commuters and leisure travellers on trains. Commuters constrained by their hours of work have less choice than other travellers and tend to travel at peak times. On the other hand, leisure travellers may be less sensitive to the time of travel and more willing to travel at off-peak times. Indeed, train companies frequently charge higher prices during peak times than during off-peak times. In such a market, the Commission might decide to define two separate markets, that is peak and off-peak markets.

- *Upstream and downstream markets*

2.31 Some products are not sold directly to the final customer. They are first sold to an intermediary, who then either sells directly on to another customer (wholesaler) or reprocesses the products before resale (reprocessor). Markets for products at an earlier stage of production are generally designated as upstream markets; and those at a later stage, typically the retail stage,

downstream markets. There may be a supply chain involving one or more upstream markets in addition to the downstream market where the final consumer purchases. The Commission's market definition will concentrate on the market or markets supplied by the merging firms, although conditions in downstream and upstream markets may affect the assessment of demand- and supply-side substitution, or competition in the particular market directly affected by the merger.

- *Market segments*

2.32 In many instances markets serve heterogeneous collections of customers, for example business and personal customers. Where this heterogeneity exists, and where suppliers can charge different prices to different groups, then depending on the inquiry and the evidence presented, the Commission may choose to treat these different groups, for the purpose of assessing competitive pressures, as separate markets. This will be particularly the case where the merger seems likely to have different effects on customers in the different segments.

- *Chains of substitution*

2.33 In the process of defining a market, two products that are not direct substitutes can at times be included in the same market. This happens when a good B, for example, is a direct substitute to products A and C, but C is not a direct substitute to A and vice versa. There is then a 'chain of substitution' running from A to B to C. Despite not being direct substitutes, A and C may, in some instances, be considered to be in the same market if they are constrained by their common relationship with B. In the presence of chains of substitution in the product market, consideration will be given to the extent to which there are breaks in the chain of substitution. Where breaks are identified it might be appropriate to define separate markets on either side of the break.

2.34 The concept of chains of substitution can also apply to geographic markets. The Commission will consider possible breaks in the chain of substitution, indicating that separate regional or local markets could be defined. Where the concept of a chain of substitution leads to a wide geographic area, the Commission will also consider whether a hypothetical monopolist would be able to price discriminate between smaller areas and, if so whether it is appropriate, instead, to define a number of smaller geographic markets.

## **Part 3: Assessment of the competitive effects of a merger**

### **Introduction**

3.1 Having defined the market, the Commission will move to its consideration of the competitive effects of the merger. This part deals with intra-market rivalry in general, before considering the possible effects of, specifically, horizontal mergers, and looking at how a merger might impact on rivalry as well as any unilateral or co-ordinated effects of the merger. It then considers other competitive constraints on firms, such as barriers to entry and countervailing buyer power. Finally it considers failing firms, vertical mergers and other types of mergers, before turning to the questions of remedies in the next part.

### **Intra-market rivalry**

3.2 When assessing the degree of competition in the relevant market, there are a number of measures and factors that the Commission will normally consider. Two commonly used measures are market shares and measures of concentration. The next paragraphs look at such measures before looking at other factors that may be relevant to investigating intra-market rivalry.

### ***Market shares and concentration***

3.3 The market shares of firms in the market, both in absolute terms and relative to each other, can give an indication of the extent of a firm's market power. For instance, a firm with a large market share relative to other firms in the same market may have the ability to raise its price independently of other firms at least to some extent. Further, a large market share may confer substantial advantages in bargaining with suppliers upstream, or buyers downstream, and a firm may be able to control prices in its favour or impose unreasonable restraints in the negotiation process. However, a firm with a relatively large market share will not always be able to exert market power. Other features of a market will affect a firm's ability to exercise its market

power, such as the extent of switching costs, threats of entry and countervailing buyer power.

- 3.4 Changes in market shares over time may give some indication of the dynamics of the market and may be useful in assessing the nature and extent of competition in the market. When considering such changes, the Commission will aim to look at market shares over several years where the information is available. Volatile market shares may indicate the existence of effective competitive constraints against the exercise of market power in the form of successful entry, rivalry between firms and innovation. However, high and static market shares do not always indicate that a firm has market power: the firm may simply have competed successfully on a continuing basis.
- 3.5 In order to calculate market shares, the Commission may use information from a variety of sources including the main parties, other competitors, customers, buyers, suppliers, trade associations and market research reports. Market shares can be measured in terms of revenues, volumes, production capacities or inputs, depending on the markets concerned and the information available.
- 3.6 The Commission will also normally look at measures of the degree of concentration of the market (which are primarily measures of the structure of the market). Concentration measures can be indicators of the ability of the leading firms in a market to exercise market power collectively though other competitive constraints will need to be considered before finding that firms have such market power.
- 3.7 There are a number of possible ways of measuring the degree of concentration in a market. A straightforward count of the firms in a market is a very basic measure of concentration as it does not convey much information about the structure of the market - as it fails to take into account differences in market shares and the size distribution of firms. Two measures that are commonly

used are the concentration ratio and the Herfindahl-Hirschman Index (HHI). The concentration ratio measures the combined market share of the largest firms in a market. For example, the ‘five firm’ concentration ratio measures the combined market share of the largest five firms in the market, and as such is simply the sum of the market shares of the five largest firms in the market. It does not, however, provide any information on the relative size of the firms nor on the number, or size, of the smaller firms. The HHI, in contrast, takes account of all firms in the industry and their relative size. It is defined as the sum of the squares of all the market shares in the market.<sup>19</sup> Other measures may be more appropriate in certain cases and will be taken into account by the Commission when relevant. In some jurisdictions, notably the US, concentration measures are used as an initial screening device to identify those mergers that seem likely to raise competition concerns. The Commission is not involved with the screening and as a result does not propose to place weight on concentration thresholds of this sort.

### ***Other structural factors***

3.8 There are a number of other structural factors beyond market shares and market concentration that can affect the degree of intra-market rivalry in a market. For instance, the extent of intra-market rivalry may depend on whether firms’ cost structures are very similar or not, and how low-cost firms utilise this advantage. In addition the degree of spare capacity in a market and the ease with which existing capacity can be expanded are two factors that might impinge on the degree of intra-market rivalry. Furthermore, the ownership and organisational form of firms might also affect the degree of intra-market rivalry.

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<sup>19</sup> The HHI for an industry with N firms and where  $s_i$  is the market share of firm  $i$  is:

$$HHI = \sum_{i=1}^N s_i^2$$

### *Network Effects*

3.9 Certain markets are characterised by network effects. Such effects arise when the value of a product to a customer increases with the number of other customers consuming the same good. As a result, incumbents with an existing customer base have an automatic advantage over entrants. Markets characterised by network effects may be prone to ‘tipping’. That is, as one firm, or technology, gains an advantage in the market, in effect the balance of power in the market ‘tips’ in its direction leaving it as the prevalent firm, or technology. An example of this was the emergence of VHS developed by JVC as the standard video technology over Sony’s Betamax at the beginning of the 1980s. In these markets, competition takes place for the market as opposed to within the market and traditional methods of analysis, such as market shares and market concentration might not successfully illustrate the degree of competition in the market.

### *Switching costs*

3.10 Another structural factor that might impinge on intra-market rivalry is switching costs. In some markets, customers face obstacles to switching between suppliers. These may take many forms including inconvenience, monetary costs, administrative hurdles or a lack of information about the products of alternative suppliers. The existence of switching costs may mean that suppliers can charge high prices to captive customers and this may have implications for market definition as well as for the assessment of competition. Against this, the presence of switching costs may intensify the competition for new customers, which may benefit new buyers. The overall effect on competition will depend on weighing up these effects. This in part will depend on whether there is scope to charge different prices to new as opposed to existing customers. Much the same set of considerations apply where there are network effects, since these effectively give rise to collective switching costs, locking consumers into existing standards and the firms that control them.

### *Information asymmetries*

3.11 A further factor that might affect the level and nature of intra-market rivalry is the balance of information held by customers and suppliers. A common feature of markets is that customers may not always be able fully to assess the quality of a product before making a decision to purchase. This can be so when products are complex or when purchased infrequently. In markets where sellers have more information than customers regarding the quality of the products, the competitive process can be significantly affected. Information asymmetries of this type can, in the absence of corrective measures, distort market behaviour. Whilst the effects of asymmetric information may be mitigated, to some extent, in various ways it may not always be possible to eradicate such asymmetries entirely.

### *Conduct of firms*

3.12 There is more to the assessment of intra-market rivalry than purely structural factors. Markets with a similar structure can display different degrees of intra-market rivalry as a result of many factors. The different ability of, and capacity for, firms to innovate might be a factor affecting the level of intra-market rivalry. Other examples might include the objectives and culture of the firms in the market, their views on the future development of the market and on the appropriate strategies to meet those developments. The history of pricing behaviour in the market and the extent to which transparent prices are available in the market might also be of interest. To the extent that these can be identified during the course of an inquiry, these factors might well provide additional insight to the more static analysis of market structure. In short, the Commission will seek to assess the process of competition and consider the kinds of factors that determine its effectiveness.

### *Non-price factors in competition*

3.13 Competition encompasses both price competition and non-price competition, and the latter can in some markets be more significant. Where applicable, the

Commission will consider the degree of non-price competition in a market, for example product development, product range and quality, marketing, servicing and research and development (R&D). An emphasis on non-price competition may reflect the characteristics of the product or customer, but may also result from incentives not to compete on price alone or a desire to raise barriers to entry. Equally, if strong non-price competition in the relevant market leads to substantial product differentiation, then this may mean that co-ordinated price behaviour is more difficult or impossible to achieve.

3.14 For example, oligopolistic firms may each face incentives to delay introducing new product developments if this would precipitate equivalent development from competitors, thereby undermining the profitability of the existing product range. However, as in the case of co-ordinated price effects the strength of this incentive will generally depend on how quickly it is anticipated that competitors could respond. If a long time-lag is envisaged then the threat to existing profitability is more likely to be discounted. Firms may also avoid competing in the same geographic markets, or refrain from competing in terms of very similar products.

3.15 While non-price competition that leads to product differentiation may make co-ordinated behaviour less likely, it may also segment the market, facilitating price discrimination schemes that may act to the detriment of the customer.

### **The effects of horizontal mergers**

3.16 Horizontal mergers involve the merger of firms that operate at the same level of the supply chain of a particular product. The main effect of a horizontal merger is to remove an independent existing competitor to firms in the market. Therefore the Commission will need to consider what the likely effect of the removal of this single firm from the market will be. What

follows considers the effect of a merger on intra-market rivalry before considering two specific effects that may occur as a result of a horizontal merger: unilateral and co-ordinated effects. Unilateral effects occur when the merged company is able on its own to exploit increased market power. Co-ordinated effects occur when a group of firms through various means attain increased market power as a result of the merger. The Commission will investigate whether such behaviours are likely to be created or strengthened following the merger.

### ***Impact on rivalry***

3.17 In its analysis of the effect of the merger on intra-market rivalry the Commission will consider the effects that the structural change brought about by the merger are expected to have on the competitive constraints existing in the market. This analysis will be set in the context of the degree of competition with the merger as opposed to without the merger. When assessing the degree of competition in the relevant market with the merger, the Commission will reconsider all those factors outlined in the previous section on intra-market rivalry. As noted earlier, two commonly used measures are market shares and measures of concentration. Generally speaking, the smaller the increment in market share brought about by the merger, the less the threat to the effectiveness of competition. However, a small increment to an already large market share may be regarded as a sufficiently significant change to the structure of a market for the merger to lead to a SLC. The higher the level of concentration resulting from the merger and the larger the increase in concentration brought about by the merger, the more likely the Commission is to be concerned about the effects of a merger.

3.18 The Commission will have regard to the combined market shares of the merging parties. There is no particular market share threshold that will denote the likelihood of the Commission deciding that the merger has

resulted in or is expected to result in a SLC. However, a combined market share of 25 per cent or above (not to be confused with the jurisdictional share of supply test) would be sufficient to raise potential concerns regarding the effect of the merger on competition. Mergers which result in a market share below 25 per cent are less likely to raise such concerns although the possibility, depending on how the market operates, cannot be ruled out.

- 3.19 Another factor which might need consideration is whether any efficiency gains result from the merger. If such efficiencies have arisen or will arise as a direct result of the merger, they will have a positive effect on rivalry in the market, such that there may be no reduction in rivalry despite the combination of erstwhile competitors. For example, a merger of two of the smaller firms in a market resulting in efficiency gains might allow the merged entity to compete more effectively with the larger firms. However, such efficiency gains are easily claimed and the onus will be on the parties to demonstrate that the gains genuinely make rivalry stronger than it would be without the merger.
- 3.20 If, with the merger, there is significant intra-market rivalry it is unlikely that competition concerns will arise. However, if intra-market rivalry with the merger is not significant, or if the merger creates significant unilateral or co-ordinated effects, then other competitive constraints on firms in the market will also need to be considered.
- 3.21 The Commission will need to assess whether the merger of itself raises barriers to entry or makes it more feasible for firms in the market to carry out behaviour which could deter entrants. Thus the Commission will have to consider whether the merger itself will affect other competitive constraints as well as intra-market rivalry. The next sections consider the possible unilateral and co-ordinated effects of horizontal mergers and then other

competitive constraints on firms such as barriers to entry, expansion and exit, and countervailing buyer power.

*Unilateral effects of a merger*

3.22 Unilateral effects occur when a merger enhances the ability of the merged firm to exercise market power, assuming that the degree of rivalry or coordination between the other firms in the market is left unchanged by the merger. The larger the market share of the merged firm, the greater the effects will generally be, though as already explained, market power is not assessed on the basis of market share alone. The Commission will need to assess whether the increment of market power resulting from the merger is significant enough to constitute a SLC.

3.23 Mergers in markets where the products are very similar (homogeneous products) can lead to unilateral effects when competitors of the merging firms are capacity constrained. If competitors are unable to increase supply substantially, a rise in price initiated by the merged enterprise could be profitable; however, substantial excess capacity elsewhere in the market will tend to inhibit this.

3.24 Unilateral effects can also occur in markets for differentiated products. Differentiated products are similar, but they are not perfect substitutes for each other, and the degree of substitutability between products may vary. The merger of two firms producing differentiated products in the same market can lead to a SLC where it allows the merged firm unilaterally to increase the price of one or more products. This is particularly likely when a

large proportion of customers of the two firms view the two products as close substitutes—eg their first and second best choices.<sup>20</sup>

3.25 Information that might be useful in assessing the relevance of unilateral effects includes:

- the type of products (whether they are homogeneous or differentiated);
- market shares;
- production capacities;
- as well as other competitive constraints such as barriers to entry, expansion and exit and countervailing buyer power.

### ***Co-ordinated effects of a merger***

3.26 Where markets are sufficiently concentrated, the actions of individual firms can have identifiable effects on their competitors, such that firms recognise their interdependence (oligopoly). This factor will be taken into account in the analysis of the effects of a merger in such a market. The interdependence of oligopolistic firms may lead them to anticipate competitors' responses to their own actions and take this into account in their own decisions. If, as will often be the case, this interdependence persists through time in such markets, the repeated nature of such decisions can have significant effects on business strategies and on competition. In particular, under certain conditions discussed below, it can become rational to refrain from initiating price cuts which would be unavoidable in more competitive circumstances. If a reduction in price fails to achieve a significant volume response it will be unprofitable; but if it does achieve such a response this will, in a sufficiently concentrated market, be likely to provoke a matching price reduction from the competitors who will necessarily have lost significant demand, with the

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<sup>20</sup>For example, two firms producing A and B are merging. The Commission might consider evidence on the proportion of sales going from A to B following a hypothetical price rise of A. If all the sales were to go from A to B, then this would be a strong indication that the merger is likely to lead to a loss of competition.

prospect that the price cut will again prove to be unprofitable. Recognition of this – namely that firms have a clear common interest in avoiding mutually destructive price cuts—may be sufficient to deter a cut in price. Moreover, price increases by one firm to levels that might otherwise have been uncompetitive may well prove profitable because, of the two possible responses by competitors—to follow or not to follow the price rise—the belief that the former will be more profitable may lead to a reasonable expectation that the original price rise will be matched. Recognition of this could then provide rational grounds for the initial price rise. Such considerations, whether explicit or implicit in terms of established pricing strategies, understanding of ‘going rates’ etc can result in oligopolistic firms all matching each others’ prices at a higher level than could otherwise be sustained.

3.27 A number of conditions are necessary for such behaviour to occur and be sustainable through time. First, the market has to be sufficiently concentrated for firms to be aware of the behaviour of their competitors, and for any significant deviation from the prevailing behaviour by a firm to be observed by other firms in the market. Where prices are transparent this will be clear. However, even where they are not, as is often the case in intermediate markets, such action by a competitor may nonetheless be readily apparent, because the essence of interdependence is that price cuts by one firm will have a significant impact on others’ volumes.

3.28 Second, it must be clear that it will be costly to firms to deviate from the prevailing behaviour. In many cases, the mere fact of the interdependence and hence the strong likelihood of a matching price cut may well be enough to create a disincentive. Timing will, however, be significant here. If prices can be adjusted quickly then such a response is very likely but in markets where prices can only be set infrequently, the short-term gains from lower prices until a response is possible could outweigh the long-term gains of

higher oligopolistic prices. If price setting is very infrequent then the basic perception of interdependence may cease to hold at all.

3.29 Third, this type of parallelism can only be sustained in markets where there are relatively weak competitive constraints. If barriers to entry are low, then the threat of entry will tend to undermine such conduct. Alternatively, if there is a fringe of other firms in a market outside the core oligopolists, and if the fringe firms have both the incentive to undercut and scope to attract significant volume away from the core oligopolists, then an uncompetitive price level is unlikely to be sustainable.<sup>21</sup> This will largely be a factual matter, depending on the number and size of such fringe companies, their costs and profit margins. It will also depend critically on their scope to expand output a) in relation to their current levels and b) in relation to the output of the core oligopolists. To the extent that fringe firms can significantly expand their own output, there will be an incentive to undercut the existing price level. If, however, this scope is limited then pricing up to the ‘umbrella’ price set by the core oligopoly may be more profitable. Even if a lower price strategy is preferable this will only tend to undermine the prevailing price level if the loss of output by core companies to the fringe is sufficiently large in relation to the output of the core oligopolists. It should be noted that co-ordinated behaviour could also occur with non-price variables such as quality, variety and innovation.

3.30 The type of behaviour discussed in the above paragraphs is sometimes referred to as ‘tacit collusion’ or ‘conscious parallelism’. However, it does not require any type of collusion, in the usual sense of the word, between firms, or even any contact between them. Nor, as noted above, does any such parallelism of price necessarily have to be ‘conscious’ in the form of an explicit or documented analysis of interdependent price strategies. The

outcome described can emerge purely from the independent recognition of the interdependence of conduct and the gains from anticipating the rational but independent responses of competitors.<sup>22</sup> It is nonetheless capable of weakening competitive pressures on prices and, if so, is likely to be detrimental to both consumers and the extent of rivalry in a market.

3.31 The Commission will want to evaluate other characteristics of the market that may facilitate co-ordination. These can include:

- A high level of concentration in the market;
- The existence and significance of entry barriers;
- Evidence of a long-term commitment to the market by firms;
- A high degree of homogeneity of the firms' products;
- A high degree of homogeneity of firms (ie the extent to which firms are similar, for instance, with respect to their size, market shares, cost structures, business strategies and attitudes to risk);
- A high degree of market transparency (the more transparent the market the easier it is for firms to see each other's actions);
- The existence of institutions that may aid co-ordination, for example information sharing agreements, trade associations etc;
- The existence of switching costs;
- The degree of excess capacity in the market (for instance a high level of excess capacity will make co-ordinated effects more difficult if some firms have a strong incentive to utilise their excess capacity);
- The stability of demand and costs (unpredictable changes in demand or costs might make it more difficult for firms to decipher whether a change in volume sold, for instance, is due to the actions of another firm or due to demand changes in the market as a whole);

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<sup>21</sup>The term "competitive fringe" is often used by economists to describe a group of relatively small firms in the market.

<sup>22</sup>Such outcomes are often described as 'non-cooperative' to distinguish them from 'co-operative' ones where companies do, formally or otherwise seek to reach..

- Limited short-term financial pressures on firms (short-term financial pressures may encourage firms to depart from any common pattern of long-term behaviour);
- The extent to which small firms on the fringe of the market, for example, producing specialist 'niche' products might embark on large scale or more developed production;
- The extent to which there is strategic intervention by interested third parties (buyers and suppliers for example);
- The scope for, or pressure on, firms to bring new products into the market;
- The degree of buyer power.

The Commission will seek to assess how in the circumstances of the case, the factors above interact with the structural change resulting from the merger to make coordinated effects a likely outcome of the merger.

3.32 One problem in identifying such conduct is that similar or identical prices can also result from intense competition. Therefore, the observation that prices are similar, and even that they tend to move together, does not of itself demonstrate oligopolistic pricing of the type described above. Indicators, or ways of distinguishing intense competition and oligopoly pricing, include first, the level of profitability generated by the price levels established. If profits are excessive then this will tend to be an indicator of oligopoly pricing. A second indicator might be that prices in competitive conditions, though tending to the same level, are, over time, likely to exhibit significant volatility as they respond to changing supply and demand conditions. This is less likely to be the case with oligopoly pricing, because the incentive not to depart from an established level of high prices will to some extent dampen the responsiveness of prices to costs and demand changes.

### **Barriers to entry, expansion and exit**

3.33 Where, in the light of its impact on intra-market rivalry, a merger might be expected to result in a SLC, it will be necessary to consider other potential competitive constraints which could offset this effect. This section considers the potential for entry and expansion in the market. It looks at entry and expansion in general before focusing on different types of barrier such as natural or intrinsic barriers, regulatory barriers and strategic barriers. It then goes on to consider the effects of entry before turning to countervailing buyer power—another possible competitive constraint.

3.34 Entry and expansion might take a number of forms including: new firms building new capacity; existing firms within the market building new plants or capacity; the entry of new firms into the market taking over existing capacity and using it in new, or more productive, ways; and new technology facilitating new production methods, potentially increasing entry possibilities. Where there is a threat of entry or expansion, it can act as a constraint, preventing the merged enterprise from exercising market power. A SLC as a result of a merger is thus unlikely where entry is easy, provided that such entry is sustainable and likely to have an impact on the potential for existing firms to exercise market power.

3.35 In assessing the potential for entry to act as a competitive constraint, the Commission will consider information on a number of factors including:

- the history of past entry and evidence of planned entry or expansion by third parties;
- the extent to which past entrants have successfully gained market share and, more generally, the cost of gaining a significant share of the relevant market (usually considered as 5 per cent);
- direct observations, or statistical information, on barriers to entry, expansion and exit;

- the costs involved in entry or expansion and in operating at the minimum efficient scale necessary to achieve a reasonably competitive level of costs;
- the likelihood of entry (from new entrants in related markets and/or from scratch) within such a time scale that it bears on the incentives and decisions of the existing firms in the market;
- the cost of exiting the market—if this is high it may deter entry by raising the cost of failure for new firms;
- the potential effect of technological change and innovation on barriers to entry; and
- the likely response to entry by incumbent firms.

3.36 In considering historical evidence, relevant factors include survival rates, i.e. how long any entrants traded in the market; the effects that entry had on competition in the market, in particular whether past entry modified the pattern of behaviour and competition; and, if so, whether this would be relevant for the present analysis.

3.37 The effects of any given set of barriers to entry will to some extent depend on other characteristics of the market. If growth in demand is likely to be large and/or rapid, then barriers to entry are less likely to have a lasting effect. Similarly, in markets characterised by innovation, product cycles are likely to be shorter, which may decrease the probability that some barriers to entry will have a lasting effect.

3.38 Barriers to entry are features that prevent or restrict potential entrants from exploiting profitable opportunities in a market and hence enable existing suppliers to raise prices above costs persistently without significant loss of market share to new entrants. Some barriers are “natural” or “intrinsic” in the sense that they are a function of the technology, production methods or some other factor necessary to establish an effective presence in the market. Some

are “regulatory”, such as rules designed to provide safety, or other types of consumer protection that may make it difficult for new firms to develop products. It should be noted that the concept of regulation in this case is broader than the conventional sense and includes things such as intellectual property law, the planning regime, voluntary or compulsory standards and codes of practice for example. Other barriers to entry, termed “strategic”, are the result of existing firms in the market acting with the specific intention to deter entry.

***Natural or intrinsic barriers to entry***

3.39 Natural or intrinsic barriers to entry are the unavoidable costs necessarily incurred when setting up or expanding a commercial operation. These include the cost of putting the production process in place, gaining access to essential facilities or inputs and the acquisition of any necessary intellectual property rights (IPRs). An important consideration in evaluating the effects of such barriers is the extent to which the costs associated with them are ‘sunk’ costs.

3.40 Sunk costs are those costs incurred by an entrant that cannot be recovered fully upon exit, because the inputs cannot be used to produce other goods and cannot be successfully traded. They include, for example, specific asset investments, advertising and R&D. In some markets, a reputation for producing quality products is needed to attract customers: the costs of acquiring such a reputation can be a form of sunk costs. As noted earlier, the existence of high sunk costs is likely to deter entry by raising the costs of leaving the market. Non-sunk costs, in contrast, by definition are recoverable if production ceases, and do not therefore pose the same risk.

3.41 In industries where economies of scale are significant, entry on a small scale may not be economically feasible unless the entrant is aiming at a differentiated ‘niche’ in the market or can develop a new production strategy

which offsets the disadvantages of small-scale production. But entry on a large scale will often raise the risk of entry because large scale entry will generally be successful only if the entrant can expand the total market significantly, or substantially replace one or more existing firms. Entrants can also be at a disadvantage where production costs are reduced according to the cumulative quantity produced ('learning by doing'). Similar considerations apply to economies of scope, which arise where producing two (or more) products is less costly for a single firm than for two (or more) firms each to produce one of the products separately. Where economies of scope are significant, a successful entrant might have to produce a range of products from the outset.

- 3.42 Where substantial financing is required for entry, the Commission might want to consider whether raising capital to finance the set up of a new operation is likely to be difficult and whether the actual cost of financing would be relatively high. Financiers might regard new entrants as high risk because they do not have a proven track record in the market and consequently provide higher cost finance to new entrants as opposed to incumbent firms.
- 3.43 Existing firms within the market sometimes have access to superior or scarce resources which entrants cannot gain access to because the supply is limited or the cost prohibitive. This might again act as a barrier to entry by, in effect, raising the input cost to entrants relative to existing firms.
- 3.44 Natural or intrinsic barriers to entry often accrue simply because incumbents are already in the market and as a result have a cost, or demand-side, advantage over entrants. Alternatively, incumbent firms may derive some benefit from simply being a known business in the market and as such there may be a reputational barrier that new entrants would have to overcome. In addition a firm will often have to incur costs to launch a product in order to

gain consumer awareness and this can act as a barrier to entry. The existence of switching costs may also increase the costs of entry, making it harder to gain customers from incumbents' existing customer base. In some markets the first firm to innovate or introduce a product or create a substantial capital base will gain a competitive advantage which competitors can overcome only with difficulty.

- 3.45 Network effects (see paragraph 3.8) may constitute an absolute barrier to entry as incumbents with an existing customer base have an automatic advantage over entrants. However, when demand is growing fast, or innovation is rapid, the barrier might not be as high as when demand or technological change is more static.

***Regulatory barriers to entry***

- 3.46 Regulations are beneficial for a variety of reasons ranging from ensuring the stability of the financial system to protecting the environment. Notwithstanding this, regulation may inhibit the extent to which competition can flourish in certain circumstances. Some types of regulation may concern the production process and the characteristics of the finished product, for instance health and safety standards. Others may limit the number of competitors in the market, for example by requiring that only firms with a licence or permit may operate in the market. A limitation on the number of licences and permits may act as an absolute barrier to entry. If licences and permits can be traded in a competitive market, then a potential entrant could enter the market by buying a licence, though this would depend on how frequently such opportunities arose. Subsidies, tax relief and preferential purchasing may also raise barriers to entry in a market if potential entrants are not equally eligible for them. New entrants may also find it hard to receive planning permission. IPRs such as patents, trademarks and copyrights give the owners of such rights exclusive use of them and the ability to control their use by others, though the period of such exclusivity or

control varies according to the nature of the IPR. Whilst IPRs are a way by which firms and individuals are incentivised to invest and innovate they can also act as barriers to entry as access to certain rights owned by an incumbent may be vital for entry. In some such cases it will be more appropriate to assess the impact on competition for the market rather than within the market.

- 3.47 Quality, environmental, health and safety standards that apply indiscriminately to all the firms in a market may on occasions adversely affect entry although they make no distinction between incumbents and new entrants. For example, they may favour the technology which the incumbent owns and in so doing raise the costs of a new entrant. Some regulations may give advantage to incumbents by not requiring them to comply with the same standards as new entrants. For example, existing high pollution factories often have grandfather rights to pollute, because the factory existed before the relevant regulation came into force, which would not be enjoyed by entrants.

***Strategic barriers to entry***

- 3.48 Firms that are already operating in the market may sometimes have the ability to pursue strategies designed to deter entry, for example, by investing in excess capacity or launching predatory price or non-price initiatives targeted at entrants when they are most vulnerable. Switching costs, for instance, may be intrinsic to the market, but may also be affected by the actions of firms. The existence of significant switching costs may act as a barrier to entry, especially when there are economies of scale. Firms may act to increase such switching costs, so strategically increasing barriers to entry, for example by offering fidelity discounts. Furthermore, existing firms may produce complementary goods and tie, or bundle, them together which potentially raises the costs for an entrant who produces only one of the complementary goods. Other forms of non-price competition, such as advertising, can have the effect of increasing sunk costs, and this will tend to disadvantage entrants. Even a low level of sunk costs may be enough to deter entry given that

existing firms within the market have already incurred these costs. They may then be able to deter entry by signalling that they would respond aggressively to entry or seek to target entrants specifically to drive them back out of the market. Alternatively, an incumbent might acquire a particularly innovative firm or a firm which threatens more competition, thereby eliminating the threat.

- 3.49 Sometimes firms may, through their conduct, increase barriers to entry even though that may not be the prime purpose of their conduct. Marketing or advertising, for instance, may be designed for inter-firm competition but may make entry more difficult. More generally, firms often seek to create a reputation for good service, quality and reliability and this may prove a further obstacle to new firms seeking to enter the market who may have no track record to demonstrate their quality and reliability.
- 3.50 Where appropriate, the Commission will consider whether the characteristics of the market make such strategic behaviour likely, whether strategic behaviour has occurred in the past and whether the merger increases the likelihood of such behaviour.

### ***Effects of entry***

- 3.51 The absence of significant barriers to entry will tend to constrain what might otherwise be scope for the exercise of market power by incumbent firms. However, the Commission will wish to be satisfied not only that entry can occur within such a timescale that it bears on the incentives and decisions of the existing firms in the market, but also that successful entry will be sustainable or provide an effective competitive constraint on the merged firm. In some cases entry on a small scale may be relatively easy, for example, by using a small-scale technology, but there may nonetheless be considerable barriers to expansion to a scale that would significantly impact on competition amongst larger firms. Similarly, entry of firms producing niche

products will not necessarily constrain incumbent firms' ability to exercise their market power. In markets with differentiated products, entry at the fringe may be easy, but a niche product may not necessarily compete strongly with other products in the same market and so may not constrain incumbents effectively.

### **Countervailing buyer power**

3.52 In assessing the effects of the merger, the Commission may consider whether buyers, either because of their size or commercial significance to their suppliers, have the ability to prevent the exercise of market power by suppliers. Analysis of buyer power is relevant to the assessment of entry barriers and unilateral and co-ordinated effects.

3.53 The fact that the market is characterised by buyers that are large relative to the size of the suppliers does not necessarily mean that there is countervailing buyer power. A large buyer will only be able to constrain firms if it is able to find an alternative supplier in the case of a price rise, if it can switch supplier relatively easily or if it possesses a credible threat of setting up its own supply arrangements.

### **Failing firms**

3.54 In some cases whether or not one of the firms merging would fail may be an issue. Where the Commission considers that one of the firms would fail then the situation in the market without the merger may be similar to that which would result from the merger, and thus the merger itself may not lead to any significant changes in the extent of competition in the market.

3.55 In order to be considered a failing firm, the Commission will need to be satisfied that:

- the firm is unable to meet its financial obligations in the near future; and that
- the firm is unable to restructure itself successfully.

3.56 Whether and to what extent the Commission will take this factor into account will depend on various circumstances. First it will need to consider whether any other persons might have acquired the firm, its businesses or any of its assets or wish to do so. A further consideration is how the sales of the failing firm, should it exit the market, will be redistributed among the firms remaining in the market. If without the merger they are likely to be dispersed across a number of other firms then the merger, by transferring most or all sales of the failing firm to the acquirer, may well have a significant impact on competition in the market. In other cases the great majority of sales may be expected to switch to the acquiring firm anyway, in which case the merger may have little effect on competition.

### **Vertical mergers**

3.57 Vertical mergers involve the merger of firms that operate at different levels of the supply chain of a particular good or service. Generally, 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 Commission will seek to assess whether the vertical merger will strengthen the firms' position in either of the markets concerned and whether this would lead to a SLC in each or both markets. The paragraphs that follow identify a number of situations in which competition concerns might arise.

3.58 In some cases, because of a vertical merger, the market power of the firm in one market may be used to create or strengthen market power in the vertically related market. A merger between a supplier of an essential input and a downstream firm, for example, might lead to a rival firm downstream not

being supplied (known as ‘foreclosure’ of supply) or facing much higher prices.

3.59 A vertical acquisition of a new or recent entrant or of a particularly innovative or aggressive firm may be an effective means of preventing the development of competition in a downstream or upstream market.

3.60 Vertical mergers may change the conditions of competition such that co-ordinated effects are more likely. For example, wholesale prices, in upstream markets, tend to be less transparent than retail prices. Where manufacturers are vertically integrated with retailers, they are more likely to be informed about the final prices and thus co-ordinated effects may be more likely to occur. Furthermore, such a vertical integration could forestall competition between the downstream retailers.

3.61 Vertical mergers can raise barriers to entry or expansion by limiting or foreclosing altogether the access to essential inputs or means of distribution. They can also increase the difficulty and risk of entry if it means that entry has to occur at more than one level of the supply chain.

### **Other types of merger**

3.62 Many mergers involve firms that are neither in the same market nor vertically related to each other. In general, they will raise no competition issues. Occasionally circumstances can arise where this is not the case, for example a merger of two firms operating in what, on the basis of the SSNIP test, considered at competitive price levels, are separate markets but which are nonetheless the closest substitutes to each other. Each may then act as a constraint on the extent to which the other raises prices. If so, a merger would permit a further increase in prices. This is one reason why it is

sometimes necessary to consider the SSNIP test at existing prices in a merger.

- 3.63 Another such case is where the two products concerned are complements. In general, a merger should then increase the incentive to lower prices. This is likely to be advantageous to competition, provided that it does not threaten to drive out existing firms or raise entry barriers to such an extent that long term competition is substantially reduced.
- 3.64 A third example might arise where products are particularly complex, with a high ongoing service component. Contracts defining such products and services can rarely be complete, in the sense of catering for all future circumstances. In such cases, the fact of being a customer for a range of products from a firm may lead to an expectation of preferential treatment, to the disadvantage of firms providing only one of the products concerned. Here again this may in some circumstances enhance competition, but in others may lessen it, for example if it inhibits effective competition from others or progressively leads to a small number of multi-product firms, each operating in a number of highly concentrated markets.

## **Part 4: Remedial Action**

### **Introduction**

4.1 This part considers remedies, starting with the statutory questions the Commission has to answer for each merger reference if it has decided that the merger situation has an anti-competitive outcome (see paragraph 1.9). It then describes the matters the Commission takes into account when determining the appropriateness of remedies, including the effectiveness of different types of remedy, costs and proportionality. It then considers different types of remedy before closing with a description of how the Commission will take relevant customer benefits into account when deciding on appropriate remedial action.

### **The remedy questions**

4.2 If the Commission has decided on a reference under section 21 or 32 that a relevant merger has resulted, or may be expected to result, in a SLC then it has to decide the remedy questions (see paragraph 1.7 (c), (d) and (e)).

4.3 The first question asks whether the Commission itself should take remedial action. This would take the form of either using its order making powers or accepting undertakings from the parties (see paragraphs 4.45 and 4.46 below). The second question asks whether the Commission should recommend that remedial action should be taken by others, such as Ministers, regulators and public authorities, to remedy the adverse effects of a merger. Such recommendations could not bind the person to whom they are addressed. They can be additional or alternative to remedial action taken by the Commission. The third question specifically asks the Commission to address what SLC, or what adverse effects of the SLC, the remedial action to be taken is designed to address.

- 4.4 In deciding these questions, the Act requires the Commission “*in particular to have regard to the need to achieve as comprehensive a solution as is reasonable and practicable to the SLC and any adverse effects resulting from it.*”

***Consideration of appropriate remedies***

- 4.5 Although the Commission must always consider the appropriateness of any remedial action, it is unlikely that the Commission would decide to take no remedial action if it has decided that a merger results or is expected to result in a SLC. Examples of exceptional circumstances where the Commission might conclude that no action was appropriate might be where the costs of any practicable remedy seemed disproportionate in the light of the size, or expected decline, of the relevant market, or where the only appropriate remedial action would fall outside the United Kingdom’s jurisdiction. However, even in these circumstances, the Commission, having decided that no action should be taken by it, might recommend action by others; for example, that the OFT or other body with appropriate powers might keep the future conduct of the merged firm under review.
- 4.6 The Act also enables the Commission to modify a decision about remedial action after taking into account any relevant customer benefits that arise from the merger. This consideration too might lead to the decision that no action should be taken. The circumstances in which customer benefits can be considered, and what constitutes a relevant customer benefit are commented on later in this part.
- 4.7 The remedial action that the Commission will decide should be taken will always depend on the facts and circumstances of the case. When deciding what is an appropriate remedy, the Commission will have regard to such aspects as costs, proportionality and effectiveness of remedies. These are discussed in the next sections.

### ***The cost of remedies***

- 4.8 Since the Commission must have regard to the reasonableness of any remedy, it will consider the costs of any action it might decide is appropriate. However, for completed mergers the Commission will not consider the costs of divestment to the parties. This is because at the time of the merger the parties have the opportunity to seek clearance of the merger. Where such clearance is not sought and where the Commission subsequently concludes that the merger will lead to a SLC, the parties will not be able to claim that the cost of divestment should be considered in the setting of remedies as, in essence, the cost was avoidable.
- 4.9 Normally costs to the companies of foregone economies will only be considered in the context of relevant customer benefits.
- 4.10 Other costs such as environmental costs or the social costs of unemployment will not be assessed by the Commission in its consideration of remedies unless the Commission is required to do so by the Secretary of State through a specified public interest consideration; see part 4 of General Advice and Information.
- 4.11 The Commission will endeavour to minimise any ongoing compliance costs to the parties, subject to the effectiveness of the remedy not being reduced, and will have regard to the costs to the OFT in monitoring compliance with any remedies that the Commission may put in place.

### ***Proportionality***

- 4.12 The Commission will abide by the principle of proportionality in determining the appropriate remedy where a merger leads to a SLC. For example, if the Commission were choosing between two remedies which it considered would

be equally effective, it would choose the remedy that imposed the least costs or that was least restrictive.

### *Effectiveness of remedies*

4.13 Before the several types of remedy are considered in more detail, a few general observations can be made about the effectiveness of remedies.

4.14 First, a factor bearing on the effectiveness of any remedy is whether it is clear to the persons to whom it is to be directed and also to other relevant interested parties, for example, the OFT, which has responsibility for monitoring compliance and other regulators. Other examples include competitors, suppliers and customers, each of whom may have an interest in ensuring compliance and may bring to the OFT's attention any concern that a remedy is not being complied with. This consideration can be particularly relevant to remedies concerning ongoing behaviour and the Commission will consider whether it is possible to devise a remedy that is both clear and not overly intrusive in its regulation of a firm's behaviour.

4.15 A second consideration is the prospect of the remedial action being implemented and complied with. Some remedies are in effect a commitment as to future behaviour or a standard as to acceptable future behaviour. There may be less certainty with some remedies compared to others that the remedies will have the desired effect. A relevant factor will be the ease of monitoring notwithstanding the possibility of setting a compliance programme. Another is the willingness of the parties to implement and adhere to the remedy. The effectiveness of any remedy is reduced if elaborate, and possibly costly, monitoring and compliance programmes are required. One-off remedies that change the structure of the market (so-called structural remedies) are likely to be preferable to remedies that impinge upon the behaviour or conduct of firms (so-called behavioural

remedies) as they directly address the effect of the merger and will require little, if any, monitoring or compliance.

4.16 A third general consideration is the timescale within which the effects of any remedial action will occur. Some remedies will have a more or less immediate effect, either in restoring competition to the *status quo ante* or in eradicating any detrimental consequences of the merger, while the effects of others will be delayed. There may be particular uncertainty about the timescale within which results can be expected when the remedy calls for action by some other person, for example a recommendation to Government to change regulations. Clearly, given the need to protect customers from a SLC or any other resulting adverse effects of a merger, the Commission will tend to favour a remedy that can be expected to show results in a relatively short time period - so long as it is satisfied that the remedy is both reasonable and practicable and has no adverse long-run consequences.

### ***Types of remedies***

4.17 The Commission will consider any of the following types of remedies:

- (a) remedies that are intended to restore all or part of the *status quo ante* market structure, for example:
  - prohibition of a proposed merger;
  - divestment of a completed acquisition;
  - partial prohibition or divestment
- (b) remedies that are intended to increase the competition that will be faced by the merged firm (whether from existing competitors or new entrants), for example:
  - requiring access to essential inputs/facilities;
  - licensing know how or IPRs;
  - dismantling exclusive distribution arrangements;
  - removing no-competition clauses in customer contracts;
- (c) remedies aimed at excluding or limiting the possibility that the merged firm will take advantage of the increased market power resulting from

the merger to behave anti-competitively or to exploit its customers or suppliers, for example:

- a price cap or other restraint on prices;
- a commitment to non-discriminatory behaviour;
- an obligation to increase the transparency of prices;
- an obligation to refrain from conduct, the main purpose of which, is to inhibit entry.

4.18 Most of the examples above are remedies that would fall to the Commission itself to impose. Examples of remedies that would require action by other persons or bodies such as government, regulators and other public bodies include changes to regulations and measures to increase market transparency.

#### *Addressing the competition concern*

4.19 In addressing the question of which remedies would be appropriate, and would provide as comprehensive a solution as is reasonable and practicable to address the SLC, and any adverse effects resulting from it, the Commission will take account of how adequately the action would remedy, prevent or mitigate the competition concerns caused by the merger

4.20 The Commission's starting point will be to choose the remedial action that will restore the competition that has been, or is expected to be, lessened as a result of the merger. Given that the effect of the merger is to change the structure of the market, remedies that aim to restore all or part of the status quo ante market structure are likely to be a direct way of assessing the adverse effects. However, issues such as the effectiveness of the remedy, the costs associated with the remedy may mean that other types of remedy need to be considered. The Commission may decide to impose more than one type of remedy. Examples of when this might be the case follow.

### ***Prohibition and divestment***

4.21 With a proposed merger, the most effective remedy will often be the prohibition of the merger. This is usually implemented by an undertaking from the parties not to proceed with the proposal. A complication may be that the potential acquirer has a shareholding in the target company. This will usually need to be reduced to a specified maximum level, below which the Commission judges there could be no possibility of material influence, within a specified and reasonable time period. For mergers already completed, prohibition takes the form of a divestment. The Commission would expect remedial action, including divestment, to occur within a specified and reasonable time after the Commission has published its decision in order to minimise the possible reduction in the commercial value of the business to be divested. It is not possible to be prescriptive in this guidance about the period within which a divestment must be made. When deciding the period, the Commission will take account of all the circumstances including market conditions and the adverse effects to be remedied. Until the divestment is complete, measures intended to safeguard the commercial value of the business, including the appointment of a trustee or other person to monitor the process, may be implemented. The Commission will not consider the private costs incurred by firms in divesting when considering remedies. The Commission will generally require the subsequent purchase to be approved, usually by the OFT.

### ***Partial Prohibition and Divestment***

4.22 Partial prohibition and divestment (rather than outright prohibition or full divestment) may be the most appropriate remedy where the merged firms carry out activities in market or markets other than those in which the merger is expected to bring about a SLC. In these circumstances, outright prohibition or full divestment may be a disproportionate way of remedying the adverse effects of the merger. So long as the area of competition concern and the relevant part of the merged or merging firms can be clearly identified, divestment of assets, or the withdrawal of one of the parties from the market in question, may be an adequate remedy. A partial divestment might be of a

stand-alone, going-concern business, physical assets or intangible assets such as brands.

4.23 Experience shows that there are two key questions that will determine whether partial divestment can be an effective remedy:

- (a) whether the assets to be divested provide the basis of a viable business that can operate independently of the merging firms and, in a reasonably short time, say within one year, can be expected to provide effective and sustained competition to the other firms in the market; and
- (b) whether a purchaser of the assets will be capable of operating the assets and running a viable, competitive business, and have the incentive to compete with the merged firm.

The answers to these questions may indicate that other additional remedies will be necessary, for example, the licensing of know-how, or a commitment to supply the acquirer with inputs controlled by the vendors. Depending on the circumstances, similar considerations may apply to a partial prohibition.

4.24 As with full divestments the Commission will require a partial divestment to be completed within a specified period and may implement additional measures until it takes place. So too the Commission may require the subsequent purchase to be approved.

***Other structural remedies intended to increase competition***

4.25 There may be circumstances where the Commission concludes that other remedies would increase the competitive constraints on the merged firm and that the constraints would be both sufficient and timely enough for the merger to be allowed without any divestment or prohibition. Such remedies might for example facilitate the entry of newcomers to the market through a commitment by the merged firm to supply inputs that they would control after the merger, or might enable existing competitors to compete more

effectively through the licensing by the merging parties of know-how or IPRs; or the removal of restrictions in contracts that tie customers to the merged firm.

- 4.26 The Commission will always consider any remedies that would stimulate the process of competition in a market, i.e. that would “work with the grain” of competition. However, it will depend upon the circumstances whether the Commission can be confident that remedies of this type alone will be sufficiently effective to allow the merger itself to proceed. A key consideration will be the time period before the Commission can expect any significant increase in the competitive pressures exerted on the merged firm.

***Remedies aimed at excluding or limiting potentially anti-competitive behaviour***

- 4.27 Remedies aimed at preventing or limiting potentially anti-competitive behaviour allow the gains from a merger but seek to prevent or mitigate the detrimental effects of the merger for competition. Price caps or restraints, for example, are an obvious limit on the extent to which a firm with market power would be able to raise prices.

- 4.28 There are, however, several shortcomings of such remedies. They can involve detailed prescription of behavioural rules, for example to prevent discriminatory or predatory behaviour or to restrain price increases, with the danger of restraining legitimate competitive behaviour. They may not be fully effective dealing with a merger in a market where co-ordinated behaviour is a concern; it is not realistic to expect that a remedy requiring firms to ignore their rivals in their own decision-making could be effective. Behavioural remedies will usually require continual monitoring by the OFT. Notwithstanding the ability to vary subsequently any remedy imposed, behavioural remedies can also be difficult to keep in tune with current market conditions, for example if cost structures are changed by technological

developments, and can therefore introduce their own distortions to competition.

- 4.29 Behavioural remedies may nevertheless be useful as a supplement to structural remedies; for example, where the Commission imposes a partial divestment remedy, a commitment by the merged business not to approach former customers of the divested business for a limited period of time may increase the Commission's confidence that the acquirer of the divested business will prove a viable and effective competitor.

***Regulatory remedies***

- 4.30 The Commission will also consider whether to recommend that action be taken by others. This could be action aimed at encouraging increased competition in the market(s) affected by the merger. For example, it might recommend action by Ministers to change legislation or regulations that limit or control entry. Alternatively it could be aimed at preventing or limiting potentially anti-competitive behaviour, for example, a modification to a licence condition or inclusion of a new licence condition.
- 4.31 It will, of course, be for the government or other person to whom action is recommended to decide whether to act. However, the government has given a commitment to consider any Commission recommendation and to give a public response within 90 days of publication of the Commission's report. The response might set out the changes it proposes to make in the light of the report or options on which it proposes to consult. For the Commission, there will inevitably be uncertainty over whether the recommendation will be accepted and, if so, over the time period before which it will be implemented. It will be necessary to take this inherent uncertainty into account when making such a recommendation.

4.32 In general, therefore, if the Commission has determined that the merger has resulted or is expected to result in a SLC, it is likely to take action itself rather than recommend that others should take action. Exceptionally, for example, if the Commission lacked the necessary jurisdiction to impose remedies, it might choose to recommend that action be taken by others as the only option, but in general any such recommendations will be additional to any action to be taken by it.

### **Relevant customer benefits**

4.33 The Commission may, in deciding the question of remedies<sup>23</sup>

*“in particular, have regard to the effects of any action on any relevant customer benefits in relation to the creation of the relevant merger situation concerned.”*

4.34 It would not normally be expected that a merger resulting in a SLC would lead to benefits to customers. On the contrary, a SLC in a market can usually be expected to have the opposite results. Nevertheless, the possibility of such benefits cannot be ruled out as is illustrated by the example of possible customer benefits below.

4.35 The Commission will disregard any benefits that might arise from commitments that the parties may wish to offer but that do not meet the criteria of a relevant customer benefit. That is, the benefits must clearly result from the merger and be unlikely to have come about without the merger or a similar lessening of competition.

4.36 Relevant customer benefits<sup>24</sup> are limited to benefits in the form of:

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<sup>23</sup>clause 34 (4).

<sup>24</sup>clause 29.

*“(a) lower prices, higher quality or greater choice of goods or services in any market in the United Kingdom (whether or not the market or markets in which the substantial lessening of competition has, or may have occurred or (as the case may be) may occur); or  
(b) greater innovation in relation to such goods or services.”*

4.37 Customers<sup>25</sup> are customers at any point in the chain of production and distribution and are therefore not limited to final consumers and include future customers. It would therefore be a relevant benefit of a merger if, as a result of the merger, a customer in an intermediate market obtained lower prices (or higher quality) whether or not final consumers were likely to benefit.

4.38 In addition to meeting the criteria set out in paragraph 4.36 above, the Commission must believe that the benefit has accrued as a result of the merger, or is expected to accrue within a reasonable time period as a result of the merger, and that the benefit was, or is, unlikely to accrue otherwise.<sup>26</sup> The burden is upon the merging parties to provide evidence that any claimed benefit does in fact fall within the meaning of a relevant customer benefit.

4.39 In the paragraphs below, examples of possible relevant customer benefits are given, followed by an explanation of how they will be taken into account when considering whether any remedial action should be taken.

***Possible relevant customer benefits***

4.40 A merger can lead to economies of scale in production or distribution. But real benefits to the merged firm do not necessarily constitute relevant customer benefits even if the Commission is satisfied that they are

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<sup>25</sup>clause 29 (4).

<sup>26</sup>clause 29.

attributable to the merger. The prospective cost reductions must be expected to result in prices lower than if the merger did not take place. This must be the case notwithstanding the scope to charge higher prices because of the reduction in competitive pressures in the market.

4.41 Similar considerations apply where the benefit claimed is that innovation would be enhanced by a merger through economies of scale, specialisation in R&D and/or the pooling of risks. While in many industries a minimum level of expenditure or expertise may be a prerequisite for successful innovation, and this kind of synergy may be hard to achieve in the absence of the merger, the incentives to innovate may be blunted by the reduction of competition resulting from the merger.

4.42 Network industries can provide an example of another type of benefit. Where services are provided over an infrastructure network, the larger the number of customers with access to, or connected with, the network, the more highly customers value the network. Network benefits of this type can be enhanced by a merger. In passenger road transport, for example, mergers might lead to improved services to customers such as a wider choice of routes, service times and frequencies, or extended through-ticketing over previously competing networks. In telecommunications, customers could benefit from a merger that improved connections between networks as a result of greater service reliability and speedier connections. However, before deciding that the benefit is a relevant customer benefit, the Commission would have to be satisfied that it would be unlikely to accrue without the merger or a similar lessening of competition; for example, that it would not be achieved through agreement between the parties.

4.43 Vertical mergers may generate efficiencies that could potentially result in benefits to customers, such as lower prices or improved quality, even when the merger also substantially lessens competition, for instance through

foreclosure. Examples include improved coordination, for instance in product design and marketing between firms at different stages of the supply chain, lower transaction and inventory costs and removal of the “double marginalisation” that occurs when two non-integrated firms both have significant market power.<sup>27</sup>

***Relevant customer benefits and remedies***

4.44 If the Commission is satisfied that relevant customer benefits would result from a merger that also led to a SLC, it will consider whether to modify the remedy that it would otherwise put in place. When deciding whether to modify a remedy the Commission will consider a number of factors including the size and nature of the expected benefit and how long the benefit is expected to be sustained, taking into account whether as a result of the reduction of competitive pressure in the market, any immediate benefit to customers would be eroded in future. The Commission will also consider the differing impacts of the merger on different customers. It is possible that the expected customer benefits would be of such significance as to lead the Commission to take no action at all, that is, to clear the merger. Alternatively, the Commission might choose to adopt a remedy, short of prohibition or complete divestment, that reduced the detrimental effects of the SLC while preserving all or most of the customer benefits. An example would be a remedy designed to facilitate or encourage competition from other firms in the market, or new entrants to the market, though an important factor for the Commission would be the timescale in which any increase in competition would be expected.

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<sup>20</sup>Double marginalisation may occur because, in the absence of price discrimination, each non-integrated firm has the incentive to raise prices above cost without taking account of the fact that this lowers the output of the other. The result is lower output and profits (and higher prices) than if the two firms pursued a policy of joint profit maximisation

## **Undertakings and Orders**

4.45 Any remedial action the Commission chooses to make can be in the form of undertakings agreed to by the person who is to be the subject of the measure or of an order. A relevant consideration in determining the appropriate remedy will be the scope of the Commission's powers and whether the remedy that it considers to be appropriate falls within its powers. The Commission's order making powers are set out in the Act.<sup>28</sup> Schedule 8 sets out the only types of provisions that could be included in an order. In contrast, the subject matter of an undertaking is not similarly limited to those matters. The process of negotiation that is involved with undertakings and the fact that their content is not limited to the matters contained in Schedule 8 may be advantageous in terms of flexibility and suitability.

4.46 In general the Commission's decision as to which form of remedy to use will be determined by issues of practicality. When the particular circumstances of the case point to the need for action to be taken speedily, the Commission may choose to implement the remedy by way of order to avoid delay while undertakings are negotiated.

4.47 The Commission welcomes the possibility of accepting undertakings that the parties put forward as being those they are willing to enter into and which the Commission considers would provide a comprehensive solution. However, even if the parties do propose undertakings, the Commission may consider alternative remedies.

### ***Procedural and other aspects of undertakings and orders***

4.48 For more information about undertakings and orders see General Advice and Information Part 7.

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<sup>28</sup> See clause 81 and Schedule 8 of the Act.

## **Part 5: Public Interest Cases and Special Public Interest Cases**

- 5.1 Merger references to the Commission may also be made by the Secretary of State when she believes that one or more public interest considerations have arisen or that a special merger situation has arisen.<sup>29</sup> The interests of national security is a public interest consideration.<sup>30</sup> Such references are made under sections 44 or 58 of the Act respectively.
- 5.2 When such references are made, the Commission will not necessarily be asked to consider whether the relevant merger situation is expected to result in a substantial lessening of competition. This will never be the case when a special merger situation is referred, and sometimes the case when the Secretary of State believes that a public interest consideration has arisen.
- 5.3 When the Commission is required to decide whether a substantial lessening of competition has resulted or is expected to result in a substantial lessening of competition, the Commission has regard to the various factors explained above.
- 5.4 If the Commission has decided that substantial lessening of competition it must also decide the following questions:<sup>31</sup>
- (a) whether action should be taken by the Secretary of State under section 54 for the purpose of remedying, mitigating or preventing any of the effects adverse to the public interest which have resulted from, or may be expected to result from, the creation of the relevant merger situation;

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<sup>29</sup>For more information about special merger situations see Part 3 of the General Advice and Information Guidance.

<sup>30</sup>The public interest considerations are specified in clause 57 of the Act. The Secretary of State may by order specify other considerations and may remove or amend any considerations so specified.

<sup>31</sup>clause 46(7).

- (b) whether the Commission should recommend the taking of other action by the Secretary of State or action by persons other than itself and the Secretary of State for the purpose of remedying, mitigating or preventing any of the effects adverse to the public interest which have resulted from, or may be expected to result from, the creation of the relevant merger situation; and
- (c) in either case, if action should be taken, what action should be taken and what it is to be remedied, mitigated or prevented.

5.5 In deciding these questions, the Commission is required, in particular, to have regard to the need to achieve as comprehensive a solution as is reasonable and practicable to the adverse effects to the public interest; or (as the case may be) the substantial lessening of competition and any adverse effects resulting from it. To the extent that it is appropriate in the case to do so, the Commission will have regard to the considerations mentioned above when determining the appropriate remedy.

5.6 Further information about public interest cases may be found in General Advice and Information Part 3.