Room 213/214
Orion Mall
Victoria
Mahe, Seychelles

Tel (+248 32 52 50)
Fax (+248 32 52 40)
PO Box 1207
Victoria
Mahe
Seychelles

Fair Trading Commission
Seychelles

The Fair Trading Commission

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The Fair Trading Commission

of

Seychelles

MERGERS

1. Introduction

1.1 Mergers are important for the efficient functioning of the economy. They allow firms to achieve efficiencies, such as economies of scale or scope, and diversify risk across a range of activities. They also provide a mechanism to replace the managers of underperforming firms.

1.2 In the vast majority of mergers, sufficient competitive tension remains after the merger to ensure that consumers and suppliers are no worse off. Indeed, in many cases consumers or suppliers benefit from mergers. In some cases, however, mergers have anti-competitive effects. By altering the structure of markets and the incentives for firms to behave in a competitive manner, some mergers can result in significant consumer detriment.

Scope of the Provision under FCA 2009, Section 21-24

1.3 The provisions of the Competition Act ("the Act") that apply to mergers involve a number of different elements. The standard under which a merger or anticipated merger will be assessed is whether it has resulted in, or is likely to result in, a substantial lessening of competition ("SLC").

"*All mergers involving an enterprise that-*

(a) By itself controls; .or

(b) Together with any other enterprise with which it intends to effect the merger is likely to control,

40 per cent of a market *or such other amounts as the Minister may prescribe are prohibited unless permitted by the Commission in accordance with this Sub-Part.*

Where an enterprise referred to in subsection (1) is desirous of effecting a merger, it shall apply to the Commission for permission to effect the merger.

An application under subsection (1) shall be made in the prescribed form and accompanied by the prescribed information.

Subsection (l) shall apply to any public bid for the control of an enterprise.

An enterprise seeking permission to effect a merger under section 22(1) shall-

(a) Demonstrate that if the merger was not completed it is not likely that the relevant efficiency gains would be realized by means that would limit competition to a lesser degree than the merger; or

(b) Demonstrate that reasonable steps have been taken within the recent past to identify alternative purchasers for the assets of the failing business, and describe in detail the results of the search for alternative purchasers.

A merger may be permitted if the parties establish that-

(a) The merger is likely to bring about gains in real as distinct from pecuniary efficiencies that are greater than or more than offset the effects. Of any limitation on competition that result or are likely to result from the merger;

(b) one of the parties to the merger is faced with actual or imminent financial failure, and the merger represents the least anti-competitive among the known alternative uses for the assets of the failing business

In determining, in any particular case whether to grant permission, the Commission shall take into account the following-

(a) The .structure of the market likely to be affected by the proposed merger;

(b) The degree of control exercised by the enterprises concerned in the proposed merger in the market, and particularly the economic and financial power of the enterprises;

(c) *The availability of alternatives to the services or goods supplied by the enterprises concerned in the merger;*

(d) *The likely effect of the proposed merger on consumers and the economy; and*

(e) *The actual or potential competition from other enterprises and the likelihood of detriment to competition.*

<u>Merger Control and FTC Approach</u>

1.4 Merger control aims at preventing an excessive reduction in the number of independent competitors supplying the market place so as to ensure the maintenance of an adequate degree of competition. In other words, it aims at preventing those concentrations which would substantially increase the ability for firms to engage in either abuses of a dominant position or in restrictive agreements.

1.5 A major difference from the assessment of restrictive practices is that merger control is forward looking rather than assessing the anti-competitive effects of practices that have occurred in the past, the FTC will assess the likely anti-competitive effects of the merger in the future.

1.6 In order to contribute to the efficiency of markets and ensure rapid transactions, FTC will review and authorize concentrations with no competition effects in a speedy manner so as not to delay restructuring processes. Few concentrations will require an in-depth assessment because of their significant impact on market competition.

<u>Purpose of the Guidelines</u>

1.7 These guidelines provide an outline of the broad analytical framework applied by the FTC when assessing whether a merger is likely to substantially lessen competition under FCA 2009. These guidelines have been developed by the FTC in relation to its functions.

1.8 These guidelines are designed to provide reliable, comprehensive and detailed information that merger parties, the business community, their advisers and the public can draw on to:

- Assess the likely level of scrutiny a merger will receive from the FTC—in particular, guidance is provided on when merger parties should notify the FTC of a merger.

- Increase understanding of the application of FCA 2009.

- Assist in structuring (or restructuring) mergers to avoid raisingcompetition concerns.

- Identify the types of information that will assist the FTC to reach a view on how a merger is likely to affect competition—to make informed and timely decisions, the FTC relies on the cooperation of the merger parties, customers, competitors, suppliers and any other persons or bodies holding relevant information.

1.9 It is not possible for these guidelines to cover every issue or circumstance that may arise in a merger review. In practice, individual mergers involve a great variety of facts and situations, and the analysis of particular issues may need to be tailored to the specific circumstances of a merger or deal with competition issues not specifically considered in these guidelines. Therefore the FTC will apply these guidelines flexibly and may adapt the framework to specific issues where appropriate.

2. What is a merger?

2.1 Section 2 of the FCA defines a “merger”: *means the acquisition or establishment, direct or indirect, by one or more enterprises, whether by purchase of shares or assets, lease of assets, amalgamation or combination or otherwise, of control over the whole or a part of the business of an immediate competitor, supplier, consumer or other enterprise;*

2.2 An ‘enterprise’ is defined in the Act:’ “enterprise” *means any person, firm, partnership, corporation, company, association or other juridical person, engaged in commercial activities for gain or reward, and includes its branches, subsidiaries, affiliates or other entities directly or indirectly controlled by it;.’*

2.3 An enterprise that buys or proposes to buy a majority stake in another enterprise is the most obvious example of a merger. However, the transfer or pooling of assets may also give rise to a merger.

2.4 The determination of whether a merger exists for the purposes of the Act is based on both qualitative and quantitative criteria focusing on both the concept of control and market share.

2.5 Parties will be able to apply to the Commission for 'guidance' as to whether a transaction or proposed transaction meets the definition of merger or proposed merger. This, however, does not preclude the Commission from initiating an investigation as to whether sections 21, 22, 23 and 24 apply.

Types of Mergers

2.6 Before considering the core topics that should be assessed in a merger review, it is important to understand the types of merger that may arise. Absent this, it is difficult to provide a coherent framework to explain how they will be analysed.

2.7 The majority of the issues discussed relate to horizontal mergers because these are the most common type of merger where competition issues arise. Other types of merger where competition issues are less likely to arise are non-horizontal, i.e., vertical and conglomerate. An individual merger may, of course, involve more than one of these types – for example, a predominantly vertical merger with some horizontal aspects. Indeed, in some of the most complex transactions, FTC needs to address multiple theories of harm in the same case.

2.8 Whichever type or combination of types of merger, the analysis compares the anticipated state of competition with the merger with the counterfactual (i.e., the likely competitive situation in the foreseeable future if the merger did not take place).

Horizontal Mergers

2.9 A horizontal merger is one between parties that are competitors at the same level of production and/or distribution of a good or service, i.e., in the same relevant market - for example, two suppliers of sugar in the same geographical area. It is the elimination of rivalry between the overlapping activities of the merging parties that may directly lead to harm to – or loss of – competition.

2.10 The FTC focus of analysis is on evaluating how the competitive incentives of the merging parties and their rivals might change as a result of the merger. The merging parties may realize efficiency gains and in some circumstances this may intensify rivalry and be beneficial for consumers. It is the FTC's task to ensure that the merger is not likely to enable firms to harm consumers or customers (where products or services are not sold directly to final consumers), e.g., by profitably raising prices, reducing quality or restricting innovation.

2.11 There are two conceptually distinct means by which a horizontal merger might affect competition (although a merger may raise both types of concerns). These two mainstream theories of competitive harm are set out below:

- **Unilateral effects.**
- **Coordinated effects**

Non-Horizontal Mergers

2.12 There are two basic forms of non-horizontal mergers: vertical and conglomerate. Vertical mergers are mergers between firms that operate at different but complementary levels in the chain of production (e.g., manufacturing and an upstream market for an input) and/or distribution (e.g., manufacturing and a downstream market for re-sale to retailers) of the same final product. In purely vertical mergers there is no direct loss in competition as in horizontal mergers because the parties' products did not compete in the same relevant market. As such, there is no change in the level of concentration in either relevant market.

2.13 Vertical mergers have significant potential to create efficiencies largely because the upstream and downstream products or services complement each other. Even so, vertical integration may sometimes give rise to competition concerns. A key question is whether the vertical merger is expected to force rivals from the market, raise their costs levels or raise barriers to entry in a manner that lessens competition. In some jurisdictions, such effects are usually broadly referred to as 'market foreclosure effects'.

2.14 In addition, vertical mergers could possibly raise competition concerns similar to those predicted in the context of horizontal mergers. As a result of the merger, the merger may increase the ability and incentive of firms to coordinate their behaviour in a market in a harmful way for consumers.

2.15 However, it should be noted that in general vertical merger concerns are likely to arise only if market power already exists in one or more markets along the supply chain.

2.16 In sum, when assessing vertical mergers it is fundamental to consider (i) whether or not there is pre-existing market power at one or more levels of the supply chain; (ii) which theory of competitive harm is likely to be relevant in a specific case, (iii) and whether or not the parties' economic incentives to engage in anticompetitive behaviour materially change as a result of the merger according to the predictions of the underlying theory.

Conglomerate Mergers

2.17 Conglomerate mergers involve firms that operate in different product markets, without a vertical relationship. They may be product extension mergers, i.e., mergers between firms that produce different but related products or pure conglomerate mergers, i.e., mergers between firms operating in entirely different markets. In practice, the focus is on mergers between companies that are active in related or neighbouring markets, e.g., mergers involving suppliers of complementary products or of products belonging to a range of products that is generally sold to the same set of customers.

2.18 Unlike horizontal mergers, conglomerate mergers do not entail the loss of direct competition between the merging firms in the same relevant market. A further characteristic of conglomerate mergers is that there is often a potential for efficiency gains when the products of the companies involved are complementary to each other.

3. The Competition Test

3.1 Competition is a state of ongoing rivalry between firms—rivalry in terms of price, service, technology and quality. Market participants are mutually constrained in their pricing, output and related commercial decisions to some extent by the activity of other market participants (or potential market participants). In other words, the greater the degree of competition in a market, the less market power each market participant will possess.

3.2 Mergers can alter the level of competition in a market. Some mergers enable the merged firm to meet customer demand in a way that facilitates more intense competition. Many mergers do not affect the level of competition at all because there are sufficient substitution possibilities to effectively constrain the merged firm.

3.3 Other mergers, however, lessen competition by reducing or weakening the competitive constraints or reducing the incentives for competitive rivalry.[1] Mergers that increase the market power of one or more market participants may be detrimental to consumers because they may lead to an increase in price, or deterioration in some other aspect of the service offering. The level of market power will be dependent on whether alternative actual or potential supply options are available post-merger to effectively constrain the merged firm. If market structure and circumstances mean that there is limited potential for alternative supply options or substitution possibilities to constrain the merged firm, then it will be profitable for the merged firm to raise prices despite the potential for lost sales to alternative suppliers.

3.4 Further, mergers that increase market power may decrease economic efficiency (because transactions at the margin are deterred) thereby reducing gains from trade and total welfare.

Market power and increases in price

3.5 The most obvious and direct manifestation of an increase in market power is the ability of one or more firms to profitably raise prices post-merger for a sustained period. Market power can, however, be exercised in other ways. For example, a firm with market power may:

- Lower the quality of its products without a compensating reduction in price.
- Reduce the range or variety of its products.
- Lower customer service standards, and/or
- Change any other parameter relevant to how it competes in the market.

[1] For convenience the guidelines refer to any increase in market power as accruing to sellers in a relevant market. A merger can also lead to a substantial lessening of competition among buyers in a market. In such a situation, the increased market power of a buyer may enable it to profitably reduce prices or otherwise engage in behaviour that is detrimental to suppliers.

3.6 While the exact nature of competitive detriment caused by a merged firm's increased market power will vary depending on the particular circumstances of the matter, FTC will often characterizes an increase in market power as the ability to raise prices. References to 'raising prices' in these guidelines should therefore be read as implicitly incorporating the exercise of market power in other non-price ways.

4. Substantial Lessening of Competition

4.1 The term 'substantial' has been variously interpreted as meaning real or of substance not merely discernible but material in a relative sense[2] and meaningful[3].

4.2 The precise threshold between a lessening of competition and a substantial lessening of competition is a matter of judgement and will always depend on the particular facts of the merger under investigation. Generally, FTC will take the view that a lessening of competition is substantial if it confers an increase in market power on the merged firm that is significant and sustainable. For example, a merger will substantially lessen competition if it results in the merged firm being able to significantly and sustainably increase prices.

4.3 The level at which an increase in market power is likely to become significant and sustainable will vary from merger to merger. For example, an increase in price that is very small in magnitude might also be significant. The FTC considers that firms would generally be deterred from instituting a price increase, or only be able to institute it for a transitory period, where effective competitive constraints exist or where constraints are likely to become effective within a period of one to two years.

4.4 In some markets, particular characteristics, such as the prevalence of certain types of long-term contracts between buyers and sellers, may prevent a merged firm from exercising any market power it gains through the merger until some point in the future—for example, at contract renewal. If the exercise of market power is likely to be delayed in this way, the FTC will focus on the period

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2 Australia, Senate 1992, *Debates*, vol. S157, p. 4776.

3 *Rural Press Limited v Australian Competition and Consumer Commission* [2003] HCA 75 at 41.

commencing at the point where market power would be exercised (for example, at contract negotiations).

Theories of harm

4.5 The core analysis in most merger cases will be of the effects of the merger in the relevant market or markets. In some cases this analysis might be unnecessary. If the counterfactual analysis clearly demonstrates that, no matter what the situation post-merger, it would be the same had the merger not happened, then the Commission need not spend significant time and effort on assessing the effects, as no SLC can occur in any event. Similarly, if the entry analysis demonstrates that any anticompetitive effect is likely to quickly be removed by new entry, then detailed analysis of those competitive effects might not be necessary. In most cases, however, the Commission's decision will be strongly influenced by its assessment of the merger's effects on competition post-merger.

4.6 These fall into three main categories, two of which apply principally to horizontal mergers, one to vertical or conglomerate mergers:

(a) Unilateral effects (horizontal mergers, mainly): the merger creates a supplier with sufficient monopoly power that it faces weaker competitive constraints than before the merger;

(b) Co-ordinated effects (horizontal mergers, mainly, but also vertical mergers): the merger results in a market in which it is more likely that suppliers co-operate, explicitly or implicitly, to raise prices;

(c) Foreclosure (vertical and conglomerate mergers, mainly): the merger creates a supplier whose market position is such that it has a stronger ability or incentive to restrict, prevent or distort competition, for example by giving it the ability to control inputs to its competitors' production.

Counterfactual

4.7 The concept of a substantial lessening of competition implies a reduction, a change compared to something else. This something else is the state of competition if the merger does not take place (nor had the merger not taken place, for a completed merger). An SLC occurs when it is expected there will be substantially less competition following the merger than would have occurred without the merger.

4.8 If nothing else is changing, the 'counterfactual' can be considered to be the state of competition before the merger. Thus, an SLC would be assessed by considering how competitive the market was/is before the merger, and what is likely to happen after the merger. In practice, this will normally be the Commission's approach.

4.9 However, in some cases other things will be changing so that this comparison does not accurately isolate the effects of a merger. For example, suppose two enterprises (A and B) are merging to one, when it is known that a third enterprise C is about to enter the market, for reasons unrelated to the merger. There were two enterprises in the market before the merger (A & B) and there will be two after (the combined AB and C). This might be held to imply that there is no loss of competition. However, the relevant comparison is the market after the merger (two enterprises: AB and C) compared to a counterfactual in which the merger did not take place (three enterprises: A, B and C). This may well result in an SLC, if the Commission takes the view that there would be more competition with three enterprises in the market.

4.10 In assessing the counterfactual, the Commission will consider the most likely course of events had the merger not taken place. However, if the most likely alternative to the merger would be another merger that the Commission would probably seek to prevent, the Commission would discard this possibility as the counterfactual and consider the next most likely outcome.

A special case of the counterfactual: failing firms

4.11 The counterfactual will be particularly important if one of the enterprises is held to be 'failing'.
If a supplier is going out of business anyway, then there might be no loss of competition as a result of its being taken over, even by a close competitor, and even if the resulting market structure is highly uncompetitive. As with any merger, the Commission will clear such a merger, if it believes that there is no loss of competition compared to what would otherwise have happened.

4.12 In order to conclude that there is no effect on competition because an enterprise is failing, the Commission will need to satisfy itself of the following things:

(a) The competitive constraint represented by the 'failing firm' would certainly be eliminated even without the merger, within the foreseeable future. This normally requires that the enterprise would be unable to carry on profitably, under any ownership. 'Profitability' in this criterion relates to carrying on as opposed to abandoning the market: whether revenues cover short-run avoidable costs. No return on assets is implied. An enterprise which cannot meet the interest payments on its debt may not satisfy this criterion, even if it is going bankrupt (because assets could be bought from the bankrupt enterprise and continue to be used to supply the market, as long as revenues cover the avoidable costs of doing so).

(b) No more competitive outcome is possible than sale to the acquiring enterprise. This requires, firstly, that purchase by no other potential buyer would provide any more competitive an outcome than would exist after the merger. For example, the sale of an enterprise to another in the same market might be expected to be less competitive than a sale to a company in a completely different business. A sale to the leading enterprise in the market might be less competitive than sale to a smaller player. Secondly, the Commission will consider whether competition would be better preserved by allowing the assets to leave the market or be scrapped than to allow them to be taken over by a competitor, if that competitor's market power would thereby be enhanced.

5. Analytical Approach and Methodologies

5.1 In considering the SLC test, the FTC will generally conduct their analysis under the following headings:

- Market Definition
- Market structure and concentration
- Unilateral effects
- Coordinated effects
- Market entry expansion
- Efficiencies
- Failing firm
- Non-horizontal mergers.

6. Market Definition

6.1 Proper examination of the competitive effects of a merger rests on a sound understanding of the competitive constraints under which the merged firm will operate. The starting position for identifying the scope of competition involves identifying products which are substitutable from the point of view of customers. This is the purpose of market definition. A market generally includes a group of products which compete with one another within a geographic area. When conducting market definition analysis, it is generally practical to describe the relevant product market first, and then to define the relevant geographic market.

6.2 It is essential to note that market definition is not an end in itself, but rather a step which helps in the process of determining whether the merged entity possesses, or will, post-merger, possess market power.

6.3 In some cases it may be clear that on any sensible market definition the merged firm will not possess any market power or that the merger will not enhance its market power. In either case it may not be necessary to establish which of the candidate market definitions is correct. Indeed, decisions published by established merger regimes commonly comment that it is not necessary to come to a firm conclusion on the scope of the relevant market since the merger does not appear to harm competition on any reasonable definition, including the narrowest possible definition. Alternatively, the competitive harm may be the same in more than one possible market definition. If, for example, two companies have equal market shares of the product A market and product B market (and so do all the other suppliers), then it might make no difference whether the authority considers a market for A and a market for B or a market for A and B. In such circumstances, FTC may not need to come to a firm conclusion on the scope of the relevant market.

Economic Rationale and Principles

6.4 Market definition is important for two main reasons:

- First, the exercise of defining markets provides a useful analytical framework in which to organize the analysis of the effects of the merger on competition. Firms in the relevant market offer the most immediate and direct competition to the merged entity. In this sense, market definition sets the stage on which competition takes place. For example, it enables us to assess the respective positions of the merged entity's rivals and, when considering the possibility that new competitors might enter the market, it is of course necessary to identify the market being entered.

- Second, market shares[4] the most widely used proxy for the determination of the absence or possible existence of market power - can be calculated only after the scope of the market has been defined. As an initial indicator, when the combined post-merger market share of the merged entity is expected to be high, competition concerns might arise. Conversely, when market shares are low (especially if they are low under all reasonable alternative definitions of the relevant market), then, as mentioned, it is often possible to dismiss any concerns or the need for substantial further investigation.

6.5 The market definition includes considering whether products can technically serve the same purpose, and whether they will do so in a way that is cost-effective enough for sufficient customers to consider them realistic economic alternatives.

[4] Market shares may be based on the total sales (or output or some other measure) of the product, in a defined area, to be held by the merging firms and each of their rivals in the relevant market

6.6 The scope of the market is often not always obvious. Does a manufacturer of colas compete in the market for branded cola-flavoured drinks, the market for all cola-flavoured drinks, the market for ‘fizzy’ or ‘soft’ drinks, the market for non-alcoholic beverages or some other collection of products? Its market share could vary significantly depending on which definition is used and so too may the FTC view on the effects of the merger. But neither market shares can be measured nor the competitive effects analysed until the question is resolved.

6.7 In this context, it is important to realize that not all customers are alike. One has to bear in mind that there is a distinction between the ‘average customer’ and what is called the ‘marginal customer’. The fact that many customers are 'captive' and will not switch to other products does not indicate whether there are sufficient marginal customers that are price-sensitive and would switch to another substitute. It is the latter question that is the more important for market definition.

6.8 It should be emphasized that defining a market with mathematical precision is rarely possible. The relevant market is in practice no more than an appropriate frame of reference for analysis of the competitive effects. It is essential to have constant awareness of this throughout the merger assessment process. It is important to recognize that competing products generally should not be viewed as either:

- In the market, and therefore a perfect 100% substitute for any other product in that market or

- Out of the market, and therefore offering zero substitutability or constraint on products in the market.

6.9 This false dichotomy is often referred to as the 0 -1 fallacy, that is one of the most serious pitfalls of market definition, especially in differentiated product markets (products differentiated by brand, quality, etc.). In reality, a spectrum of constraints may exist which need to be built into the analysis. Nevertheless, the conceptual framework of market definition is important as it provides an intellectually disciplined tool with which to gather and assess evidence on the sources of competitive constraints that face the merged entity and its rivals.

6.10 When markets contain differentiated products, it may be difficult to define the market exactly. Moreover, some products may be in the same market yet may be much closer substitutes for each other than other products also in the market. In differentiated product markets, therefore, market definition will need to be supported by rigorous analysis of competitive effects.

The Use of Precedents

6.11 In many cases a market may have already been investigated and defined in previous investigations. Additionally, the same merger may be being examined by other jurisdictions. Sometimes earlier definitions or approaches of other competition authorities can be informative when considering the appropriate product or area although FTC will be cautious as the conclusions on these cases may not always be applicable to the merger in question.

Product Market[5]

6.16 Market definition focuses on the empirical question of substitutability of products and services from the point of view of customers. When assessing product market scope, substitutability from both demand- and supply –side is commonly considered.

6.17 Demand-side substitutability assesses the extent to which customers could and would switch among substitute products in response to a change in relative prices or quality or availability or other features. When considering demand-side substitutability, it is generally useful to find out from the competitors which products they see as substitutes – as well as from customers where products are not sold directly to end-consumers.

6.18 Supply-side substitutability examines the extent to which suppliers of alternative products could and would switch their existing production facilities to make alternative products in response to a change in relative prices, demand or other market conditions.

Analytical framework for assessing demand side substitutability

6.19 The market definition process starts by considering the narrowest candidate market definition. This is normally a product or service which one (or both) of the merging parties supply.

[5] Annex 1. Product Market Definition: Case studies

6.20 Conceptually, one approach that can be taken to analyse the degree to which customers could and would switch is by applying the so-called **hypothetical monopolist test**. Consider a hypothetical firm that is the only supplier of the product or group of products. The question to be answered is whether a monopoly supplier (the hypothetical monopolist) of these products would maximise its profits by consistently charging higher prices.

6.21 This test is also commonly referred to as the **SSNIP test** where 'SSNIP' stands for '**s**mall, but **s**ignificant **n**on-transitory **i**ncrease in **p**rice', i.e., a significant price increase maintained over time. If the hypothetical monopolist would be prevented from imposing at least a small, but significant non-transitory increase in price because of substitution by customers to other products, the candidate market is not a relevant market by itself. The next closest product should be added to the scope of the candidate market and the test applied again. By repeating the process, a point can eventually be reached where a hypothetical monopolist supplying the products or services in question would achieve market power, i.e., the hypothetical monopolist would maximize profits by maintaining prices above prevailing levels. This point is (usually) the relevant product market. With regard to the size of price increase, the common benchmark used is between 5 and 10 per cent.

6.22 In practice, in many cases, there may be insufficient available data to conduct a full SSNIP test: in such cases, application of the SSNIP test is more likely to be conceptual rather than literal. In other words, the application of the test may be only a framework for analysis.[6]

<u>Investigative techniques used in assessing demand-side substitutability</u>

6.23 In order to conduct the hypothetical monopolist test and be clear about the scope of the market, it is necessary to obtain evidence on possible substitution by customers between the parties' product (or

[6] Apart from the issue of which prices must be used as the basis for the test, there are other issues arising from the strict implementation of the SSNIP test. One is whether the prevailing level of prices is already well above competitive levels (the so -called *Cellophane fallacy*). Another is that customers may take time to respond to a sustained rise in the price of the focal product. As a rough rule of thumb, it is generally accepted that if it takes longer than one year to substitute, the products to which customers eventually switched would not be included in the same market as the focal product. However, the one-year benchmark may not apply to certain markets and a case by case analysis of switching is therefore recommended. Further information on the hypothetical monopolist test can be found in the ICN 'Investigative Techniques Handbook for Merger Review'.

service) and competing products (or services). Information required will vary from case to case. The following sources may be of help during the process[7]:

- Evidence on **characteristics and usage of products and consumer preferences** may provide useful information. Where the objective characteristics of products are very similar and their intended uses the same, this suggests that the products are close substitutes. However, the following caveats should be noted. **First**, even where products apparently have very similar characteristics and intended use, switching costs and brand loyalty may affect how substitutable they are in practice. For instance, in some markets, private-label (non-'brand name') products[8] might have a similar – or even identical – mix of ingredients to other products with a strong brand image, but not be in the same market. In other words, loyalty of consumers to branded goods might reduce the willingness of a sufficient number of them to switch to private-label products if the prices of **branded** products increased significantly. In other industries involving both branded and private-label goods, there may be sufficient switching at the margins to lead to the conclusion that they are in the same market. Evidence on the **relevant** consumer preferences in the market in question will provide the answer. **Second**, just because products display similar physical characteristics, this does not necessarily mean that customers would view them to be close substitutes. For example, customers may not view commuter rail travel during off-peak times to be a close substitute for rail travel at peak times. **Third**, products with very different physical characteristics may be close substitutes if, from a customer's point of view, they have a very similar use. For instance, disposable lighters and matches might be in the same market.

- It may be helpful to request from enterprises involved in the merger (or indeed other firms active in the market) their commercial strategies and other internal **documents** such as internal communications, public statements, and studies on consumer preferences, market research, advertising plans, general marketing plans

[7] See the ICN Investigative Techniques Handbook for Merger Review (2005) for a comprehensive guide to techniques, tools and evidence used in merger review.

[8] These are goods that carry the brand of the retailer (e.g., a supermarket chain's 'own brand') but are often manufactured by a third party.

or business plans. These may indicate which products the undertakings believe to be the closest substitute to their own products and may also provide information on which companies they consider to be their competitors.

- Customers and competitors can be interviewed. In particular, customers can be asked directly about their historical **buying patterns**, how they have responded to previous price rises and how they are likely to react to a hypothetical price rise. However, because of the hypothetical nature of this last question, answers may need to be treated with a degree of caution. Survey evidence might also provide information on customer preferences that would help to assess substitutability: for example, evidence on how customers rank particular products, whether and to what extent brand loyalty exists, and which characteristics of products are the most important to their decision to purchase. Some care is needed here to ensure that responses are obtained from a truly representative sample. For example, it is useful to obtain evidence from customers of the merging parties and customers of competitors. Real care is needed in asking questions and analysing the views of competitors, since their self -interest may lie in promoting or undermining a merger that may decrease or increase the level of competition that they face.

- A significant factor in determining whether substitution is likely to take place is whether customers would incur costs in substituting products. High **switching costs** relative to the value of the product will make substitution less likely. The cost of switching may be established by questioning customers on any past experiences of switching.

- **Patterns in price changes,** for reasons not connected to costs, can be informative. For example, two products showing the same pattern of price changes, for reasons not connected to costs or general price inflation, would be consistent with (although not proof of) these two products being close substitutes. Pricing data may be obtained from the merging parties and from competitors. However, price correlations may be high for other reasons, and accordingly should be used with some care.

- Evidence of **product switching** by a relatively large proportion of customers to a rival product in response to a relatively small price rise in the product in question would indicate that these two goods are close substitutes. Equally, **price** divergence **over time**, without significant levels of substitution, would be consistent with the two products being in separate markets. One way to monitor this would be to look at pricing data over time and see whether the volumes of the respective products diverge in response to a price shock in one of the goods.

- Evidence on **own or cross price elasticities** of demand may also be examined if it is available. The own price elasticity of demand measures the rate at which the quantity of a product sold changes when its price goes up or down (the sensitivity of demand to changes in price). The cross price elasticity of demand measures the rate at which the quantity of a product sold changes when the price of another product goes up or down. In reality it is generally difficult to find such information. It may be calculated by obtaining pricing and sales data from the parties and competitors. Alternatively, companies may have conducted their own internal research on such matters which may be requested.

- Evidence on the **price-concentration relationship** may also be informative. Price-concentration studies examine how the price of a product in a distinct area varies according to the number (or share of supply) of other products sold in the same area. These studies are useful where data are available for several distinct areas with varying degrees of concentration. For example, if observations of prices in several geographic areas suggest that when two products are sold in the same area, prices are significantly lower than when they are not, this might suggest that the two products are close substitutes (provided that it is possible to distinguish this from the effect of other factors which might explain the price differences). It should be noted that obtaining reliable pricing and sales information for such studies may be difficult and it may be difficult to account properly for differences in demand and supply conditions across different areas.

Analytical framework for assessing supply -side substitutability

6.24 If prices of product A rise, enterprises that do not currently supply that product might be able, at short notice and without incurring significant sunk costs[9], to switch from production of product B to supplying product A. This form of substitutability occurs in the production process of incumbent suppliers and hence is known as supply**-side substitutability**. It addresses the questions of whether, to what extent, and how quickly, undertakings would start supplying a market in response to a price increase in that market.

6.25 Supply-side substitutability can be thought of as a special case of entry. Indeed, a number of jurisdictions conduct supply-side analysis as an integral part of the entry assessment rather than as part of defining the market. Whichever approach taken by FTC should not affect the overall analysis of the impact of the merger on competition. In the case of supply -side substitutability, 'entry' occurs quickly, effectively (on a scale large enough to affect prices), and without the need for significant sunk investments.

6.26 Moreover, the mere fact that some firms producing a product B are able to quickly switch (or extend) supply to product A does not necessarily mean that (i) they can switch (or extend) supply entirely, (ii) they have incentive to do so and (iii) all firms producing B would do so. When considering the product market on the basis of supply-side substitutability, the competition authorities will require that most of the suppliers of product B will be able to offer and sell the various qualities of product A under conditions of immediacy (with the capacity that can be economically reallocated to product A) and in the absence of significant increase in costs before they conclude that product A and B are in the same market.

[9] See 'sunk cost' in the OECD Glossary of Industrial Organization and Competition Law (1993) and FTC 4 Procedures for Abuse of Dominance.

Investigative techniques used in assessing supply-side substitutability

6.27 As with assessing demand-side substitutability, establishing whether supply side switching is likely to occur requires evidence on possible substitution by suppliers.FTC will consider the following sources in compiling this evidence:[10]

- During the investigation process, enterprises that may have been identified by the parties or by the case team as potential suppliers might be asked whether substitution is technically possible, about the costs of switching production between products, and the time it would take to switch producti on. The key question to ask potential suppliers, however, is whether it would be profitable to switch production, given a small (e.g., 5 to 10 per cent) price increase.

- Potential suppliers might also be asked whether they have spare capacity or are free or willing to switch production. Enterprises may be prevented from switching because all their existing capacity is tied up, for example they may be committed to long term contracts. There might also be difficulties obtaining necessary inputs or finding distribution outlets. Enterprises may be unwilling to switch production from an existing product to a new one, if producing the former product is more profitable than the latter.

- Although potential suppliers may be able to supply the market, there may be reasons why customers would not use their products (for example, quality and reliability of supply), so the views of customers might also be sought. In this regard, the points made above regarding caution when sampling the views of customers are equally applicable here.

[10] See ICN Investigative Techniques Handbook for Merger Review (2005).

The Geographic Market[11]

6.28 The geographic market is an area within which reasonable substitution for the merging parties' products can occur, i.e. to which customers can look for supply. One approach to defining the geographic market is to conceptually consider the smallest area where a hypothetical monopolist would maximize its profits by imposing at least a small but significant and non-transitory increase in price. Geographic markets are defined using the same processes as those used to define product markets.

6.29 As with the product market, in assessing the appropriate geographic market, the objective is to identify substitutes which are sufficiently close that they would prevent a hypothetical monopolist of the product or service in one area from sustaining price increase of at least 5 to 10 per cent. The process starts by looking at the narrowest area. The hypothetical monopolist test is applied to this area and repeated over wider geographic areas until the hypothetical monopolist would sustain price rises of at least 5 to 10 per cent.

7. Market Structure and Concentration

7.1 After defining a relevant product and geographic market, FTC will consider its structure and how it will change as a result of the case under review.

7.2 Key aggregation indicators used in assessing market structure and concentration include market shares, concentration ratios and the Herfindahl-Hirschman Index (HHI). Each of these is discussed below. It is essential to note that each of these measures may be used as an initial indicator or screen of potential competition concerns[12], but will not be determinative in itself. An investigation beyond these quantitative indicators, including a detailed analysis of other market features as well as unilateral and/or coordinated effects, is always required before conclusions can be drawn regarding the competitive effects of a merger.

7.3 This guideline explains the most commonly used measures of market concentration and gives guidance on how to interpret them.

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[11] Annex 2. Geographic Market: Case studies

[12] In jurisdictions where an agency must challenge a merger in a judicial court, this may take the form of a rebuttable presumption.

Economic rationale

7.4 If, in the case of a horizontal merger, A and B merge, the market shares of A, B and each of their rivals can give an initial indication of whether the loss of competition between A and B is important or, conversely, whether the remaining competitors can be expected to constrain the merged entity so much that this 'loss' is not relatively important. Generally, the higher the combined market shares of the merging firms, the more likely that the loss of competition will be important. Other concentration data can be an indicator of competitive pressure within the market. Broadly speaking, the fewer the number of firms in a market, the more likely the removal of an independent firm will present a loss of an important competitive constraint on the remaining firms. However, as said, concentration measures are only an initial screen in assessing the competitive effects of a merger.

Use of concentration measures[13]

7.5 There are several measures of market concentration. These concentration measures may be used to set thresholds to identify those mergers that are more likely to raise competition concerns and therefore require investigation. Data on market shares may be collected from a number of sources including trade associations, customers or suppliers and market research reports.

7.6 It is of critical importance that the gathered data give a good indication of how competition works in a given market. Production volumes and sales volumes are most widely used. Sales volumes may be more useful in differentiated goods markets as sales better reflect differences in product value. Capacity or reserves may also be used (for example where the product concerned is a trade commodity and production capacity therefore represents the best indication of competition strength). In bidding markets - where customers periodically invite suppliers to tender for a significant proportion of their respective demand - the number of credible bidders may be used. Before the effects of the merger can be assessed, it may be necessary to adjust current market shares to reflect expected or reasonably certain future changes, such as firms likely to exit from the market or the introduction of additional capacity.

7.7 It may be difficult to obtain figures on which to conduct concentration calculations based on the defined economic market. It is likely that available statistics are not normally collected on this basis.

[13] Annex 3. Use of concentration measures: Case studies

Figures available by product may, for example, have to be aggregated to the relevant product market and many statistics are collected on a national basis whereas this may not be the geographic market identified.

7.8 It may be useful to ask parties to compile and provide estimates of market shares. If this is done, it is essential to ask the parties how the data have been compiled, what sources have been used and what assumptions have been made in doing so. It is helpful to test the accuracy of these estimates with customers and competitors when conducting third party questioning.

Measures of concentration: Market shares

7.9 Market shares indicate the percentage of total sales (or some other measure) of the product to be held by the merging firms and each of their rivals in the relevant market. Thus, they are indicative of the past market success of each firm in the relevant market. For FTC, market shares are the starting point of the merger review.

7.10 An important indicator is the combined share of the merging parties, i.e, the sum of their pre-merger shares. The combined share of the merging parties and the increment in market share resulting from the merger are typically considered as useful screens for possible unilateral effects scenarios. It is also helpful to compare the combined market share with those of other market players.

7.11 Mergers creating a high market share for the merging firms are those that are most likely to raise competition issues. It is generally the case that mergers with an insignificant combined market share may be cleared fairly quickly. FTC will exercise caution in markets of differentiated products, as market definition itself is more complex in these cases.

7.12 Market shares provide only a snapshot of the structure of the relevant market at a point in time. However, in some markets, e.g., those characterised by large and infrequent orders made by a small number of customers, it might be useful to analyse market shares over a period longer than one year using historic data, and investigate any variance in market shares over time. Also, changes in historic market shares may provide useful information on the competitive process and its dynamic evolution: for instance, a distribution of market shares among the market participants that varies considerably over a relatively short time period might be suggestive of a competitive situation where no firm has market power; conversely, the persistence of a more rigid pattern (e.g., a firm's market share is consistently above, say, 40 per cent over a long time horizon) may be indicative of a situation of market power.

Concentration ratios

7.13 Concentration ratios measure the aggregate market share of a small number of the leading firms in a market. Concentration ratios of the first three (CR3) or four (CR4) or five (CR5) firms are usually considered. They are absolute measures of concentration and take no account of differences in the relative size of the firms that make up the leading group. By way of example, the CR3 ratio in a market where the three largest firms within that market each have shares of 15 per cent would be 45 per cent.

Herfindahl-Hirschman Index (HHI)

7.14 The HHI is calculated by summing the squares of the market shares of all the firms active in the market. The HHI potentially reflects both the number of firms in the market and their relative size.[14] Both the absolute level of the HHI and the change in the HHI as a result of the merger can provide an indication of whether a merger is likely to raise competition concerns. The increase in HHI (or delta) can be calculated by subtracting the market's pre-transaction HHI from the post-transaction HHI.[15]

For example:

- In a given market, there are six firms. Firm A (with 20 per cent market share) merges with firm B (with 5 per cent share). Three of the other four firms each have 20 per cent shares and one has 15 per cent. The post-merger HHI is:

$$\mathbf{25^2 + 20^2 + 20^2 + 20^2 + 15^2 = 2{,}050}$$

7.15 The pre-merger HHI is:

$$\mathbf{20^2 + 20^2 + 20^2 + 20^2 + 15^2 + 5^2 = 1{,}850}$$

The increase in HHI (or delta) = 200.

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[14] The HHI index can vary between 0, when the market is entirely fragmented, and 10,000, where there is only one firm in the market which has 100 per cent of the market share.

[15] The expected post-transaction HHI is calculated on the basis of the combined pre -merger market shares of the merging parties, provided that the merger does not alter market shares. Thus, a market comprising firms a, b, c and d will have an HHI of $a^2+b^2+c^2+d^2$. The delta in this market resulting from a merger between firms a and b can be calculated as $((a+b)^2 + c^2+d^2) - (a^2+b^2+c^2+d^2)$. Hence, = 2ab

7.16 Other things being equal, FTC will not worry more about a merger in a market which is highly concentrated than about one which occurs in a fragmented market. For the same reason, and whatever the existing level of concentration, FTC will pay more attention to a merger which increases in a significant way industry concentration than to one which increases it only marginally.

7.17 It is frequently not possible to calculate the HHI for the entire market because not all participants' shares are known. In such cases it may be considered more appropriate to use another concentration measure or calculate and evaluate only the increased HHI or delta (i.e., twice the product of the market shares of the parties. Alternatively, provided that shares accounting for the majority of the market are known, the HHI can be approximated even if share data for the smaller firms are not known.

7.18 Although it is difficult to generalize as to whether one measure of concentration is superior to another, the HHI arguably provides richer and less arbitrary information than concentration ratios such as CR3 and CR4 as it provides information relating to the whole of the market rather than some of the firms (usually the largest firms). It takes account of the relative sizes of the larger firms and avoids arbitrariness. If, for example, CR4 is used then a merger between the fifth and sixth largest firms might show no change in the concentration ratio, whereas a merger between the fourth and tenth largest would.

Interpreting market shares and concentration data

7.19 There is no simple answer as to how high (or low) concentration measures need to be to prompt (or dismiss) concerns about the impact of a merger on competition. The same applies to the combined market share of the merged entity.[16]

7.20 Even where the merging parties' combined market shares appear reasonably low, for example below 25 per cent, a merger may still raise a competition issue. For example, supplier A (14 per cent

[16] The project conducted by the Analytical Framework subgroup in 2005 comparing merger guidelines across a number of countries found that some jurisdictions do include 'safe harbours' (a market share and/or concentration level below which a merger will not be challenged) when assessing mergers. Safe harbours can be useful, for instance, since they may increase the predictability of merger control and allow competition authorities to allocate investigation resources to cases which are more likely to result in consumer harm.

share) merges with supplier B (10 per cent), leaving only two suppliers, the merged entity AB (24 per cent) and C (76 per cent). The post merger HHI is 6,352 and the delta is 280. In this example the high value of the HHI statistics may indicate the possibility that the impact of this merger on a market that is already highly concentrated can raise some competition issues.[17] By contrast, competition concerns may arise even with a relatively low post-merger HHI, for example, where the merging firms (say, with 20 per cent and 15 per cent shares) are the two largest in a fragmented market (say, all other suppliers are 3 per cent or less) or where they have some characteristic that is not enjoyed by the other players in the market. These examples show that market shares and HHI measures provide only an initial indicator of potential competition concerns.

7.21 Apart from this, these measures may themselves be rather inaccurate in some markets. For instance, in 'bidding markets' contracts may be awarded infrequently and a one-year snapshot of supply may not reflect the true position of companies within that market. In such cases, it is important to analyse market concentration data based on supply over several years. It is helpful and telling to assess variations in the market over time not least because volatile shares may reflect lumpy demand in bidding markets or be suggestive of effective innovation competition by firms periodically launching new products or product iterations.

7.22 With regard to the HHI level, in some jurisdictions competition authorities state they are unlikely to identify competition concerns where: (i) the post-merger HHI is below 1000; (ii) the post-merger HHI falls between 1000 and 1800-2000, and the change, or delta, is below a range of 100-250; and (iii) the post –merger HHI is above 1800- 2000, and the delta is below 50-150.

8. Unilateral effects[18]

8.1 Section 7 of this guideline considered ways to measure the impact of mergers on the level of concentration in a particular market. This section explains some possible anti-competitive effects arising from mergers. The focus of competition analysis is on evaluating how the competitive incentives of the merging parties and their rivals might change as a result of the merger.

[17] However, in the absence of any collusion, AB might be a more effective competitor to C than A and B individually.

[18] Annex 4. Unilateral effects: Case Studies.

8.2 Key to the assessment of mergers is the comparison of prospects for competition in a market with and without the merger.

8.3 There are two mainstream theories of harm by which a horizontal merger might be expected to be detrimental to consumer welfare: unilateral effects and coordinated effects.

Economic rationale

8.4 Unilateral effects, also known as 'non-coordinated effects', refer to the situation where the anti-competitive effects of the merger flow from non-coordinated action by market participants. In particular, unilateral effects arise where, as a result of the merger, the merging firms are able to exercise market power, for example, by profitably raising price, or reducing output or quality or variety (or changing any other competitive parameter) as a result of the elimination of competition between the merging parties themselves.

8.5 The most common unilateral effects scenario involves a merger of sellers of differentiated products competing on the basis of price. For instance, a firm producing product A merges with a firm supplying B. A pre-merger price increase of product A would result in customers diverting their purchasing to product B (and other rival products). Post merger, profits on sales lost to B will no longer be lost, but be kept or 'internalised' by the merged group producing A and B. It therefore has an incentive to raise the price of A. In addition, the firm may find it profitable to raise also the price of the acquired products, since it will recapture some of the lost sales through higher sales of its original products (in other words, retain business that pre- merger would have diverted from B to A).

8.6 Other firms in the market may also find it profitable to raise their prices – to continue the same example - because the higher prices of the merged firms' products will cause some customers to switch to rival's products. In other words, even if rival firms pursue the same competitive strategies as they did prior to the merger, this can result in their increasing prices following a merger. In such cases, the firms in the marketplace are not coordinating their competitive behaviour; they are simply reacting to changes in each other's behaviour. Such instances of anti-competitive effects are still termed 'unilateral' (sometimes called ‘multi -lateral’) by merger analysts since they are based on non-coordinated actions of firms.

8.7 The central economic question when assessing the foregoing unilateral effects scenario is whether, after the merger, sufficient customers switch to products of the merged firms' competitors so that in the event of a price increase the merged firm would lose sufficient sales to make a significant price increase unprofitable. Put differently, the critical issue for the investigating authorities is the assessment of the extent to which the merging parties' products are close substitutes (the diversion effects from A to B).

8.8 Unilateral effects can also arise in other contexts, including bidding or auction markets, where different firms compete to win orders. The specific model used will vary depending upon the circumstances of the market, but should have a common thread of attempting to assess whether there is any increase in market power as a result of the merger, for example, by combining the two lowest-cost bidders and thus allowing the merged firm to win with a higher bid.

8.9 The anti-competitive effects of a merger may not be limited to price increases. Indeed, when a company faces less competition it may have less incentive to produce products of such high quality or may reduce the range of products that it offers. Additionally, without competition firms may have less incentive to invest in improving their products and hence innovation may be dampened. All these factors should be considered in assessing unilateral effects.

8.10 Assessing in practice the closeness of the merging parties' products can be a very difficult task. Sources of information that FTC will use to check against each other are:

- The parties' internal documents – such as (a) business plans, marketing plans, and similar documents which are usually prepared in the ordinary course of business and which will often identify a firm's principal competitors; and (b) documents relating to board or other senior management approval to proceed with the merger;

- Customers' views in markets where the products are not sold directly to end consumers.

- Third party documents such as market intelligence reports, analysts reports, and so on.

- Documents provided to other competition authorities (assuming confidentiality rules).

Factors in understanding broader competitive constraints

8.11 When examining whether there will be non-coordinated effects arising from the merger, FTC will consider the relevant factors:

- **Low barriers to entry or expansion** – Entry by new competitors or expansion by existing competitors may be sufficient in time, scope and likelihood to deter or defeat any attempt by the merging parties to exploit the reduction in rivalry following the merger.

- **Buyer power** - The competitive pressure on a supplier is not only exercised by competitors but can also come from its customers. Even firms with very high market shares may not be in a position, post-merger, to exercise market power if customers possess countervailing buyer power. In this context countervailing buyer power means the bargaining strength that the buyer has vis-à-vis the seller in commercial negotiations due to its size, its commercial significance to the seller and its ability to switch to alternative suppliers. Countervailing power may also exist where a buyer is capable of producing the supplied product itself (through vertically integrating) or alternatively, directly importing the product. The factors to consider in making an assessment of buyer power would be (i) whether or not the customer can credibly threaten to resort, within a reasonable timeframe, to alternative sources of supply; and (ii) whether or not the buyer is able to refuse to buy products produced by the supplier or (in the case of durable goods) delay purchases. It is more likely that large and sophisticated customers will possess this type of countervailing buyer power than smaller firms in a fragmented market. Furthermore, buyer power cannot sufficiently offset the adverse effects of a merger if it only applies in relation to certain categories of customers. Finally, it is not sufficient that buyer power exists prior to a merger; it must also exist and remain effective following the merger.

- **The nature of competition within the market** – Sometimes buyers choose their suppliers through a bidding or auction process for example through procurement auctions or tenders. In some circumstances, even if there are only a few suppliers, competition might be intense. This is more likely to be the case where tenders are large and infrequent (so that suppliers are more likely to bid), where suppliers are not subject to capacity constraints (so that all sup pliers are likely to place competitive bids), and where suppliers are not significantly differentiated (so that for any particular bid, all suppliers are equally placed to win the contract). Under these circumstances, a merger would not produce significant unilateral anticompetitive effects even if the merged entity had a high market share.

- **The merging parties may not be close competitors** – In this case pre-merger market shares may not be a good indicator of levels of rivalry between the merging parties, for example their products may be differentiated such that they are not close competitors (while still forming part of the same relevant market).

- **Responsiveness of competitors** – In some cases, competitors can react by either increasing output (if spare capacity is available) or repositioning in order to place a constraint on the parties post merger.

- **Alternative suppliers exist to whom customers are willing to switch** – If there is a number of alternative suppliers to whom a significant number of customers are willing to turn, the threat of losing these customers may be enough to place a constraint on the merging parties. However, in product markets differentiated by brand or reputation, this is unlikely to happen even if customers face very low switching costs.

- **Elimination of a potential competitor/new entrant** – Some firms have more of an influence on the competitive process than their market shares or similar measures would suggest. A merger involving such a firm may change the competitive dynamics in a significant, anti-competitive way, in particular when the market is already concentrated. For instance, a firm may be a recent entrant that is expected to exert significant competitive pressure in the future on the other firms in the market. In markets where innovation is an important competitive force, a firm with a relatively small market share may nevertheless be an important competitive force if it has promising pipeline products.[19]

- **Merged entity able to hinder expansion by competitors** – Post-merger, the merged entity may be in a position where it would have the ability and incentive to make the expansion of smaller firms and potential competitors more difficult. For instance, the merged entity may have such a degree of control, or influence over, the supply of inputs or distribution possibilities so that expansion or entry by rival firms may be more costly. Similarly, the merged entity's control over patents or other types of intellectual property (e.g., brands) may make expansion or entry by rivals more difficult. In markets where interoperability between different infrastructures or platforms is important, a merger may give the merged entity the ability and incentive to raise the costs or decrease the quality of service of its rivals.

8.12 Note that this is not a checklist of factors or characteristics that must all be present before unilateral anti-competitive effects can be dismissed. These factors are intended simply as a broad indication of the circumstances in which it may be concluded that the risk of such anti-competitive effects is lower or higher. Equally, the presence of such factors may not on its own be sufficient to alleviate – or their absence sufficient to support - anticompetitive concerns. The weight given to factors needs to be considered within the context of the case.

9 Co-ordinated Effects[20]

9.1 This part of the guideline focuses on the other main way in which the competitive incentives of the merging parties and their rivals might change as a result of the merger. Firms, under certain market conditions, may not compete effectively against one another but rather coordinate their behaviour in an anticompetitive way which can take various forms, e.g., coordination on price or output or coordination via customer/market allocation. Such coordination results in a loss of consumer welfare.

[19] See OECD, Merger Review in High Innovation Markets (2003).
[20] Annex 5. Co-ordinated effects: Case studies

9.2 Given certain market conditions, firms realise that it is in their mutual interest to coordinate or align their market behaviour. However, coordination requires far more than the mere decision of firms not to compete.

Economic rationale

9.3 Coordinated effects may arise where a merger reduces competitive constraints in a market, thus creating or strengthening the conditions that facilitate the ability of competitors to coordinate their competitive behaviour. The main question in analysing coordinated effects should be whether the merger materially increases the likelihood that firms in the market will successfully coordinate their behaviour or strengthen existing coordination.

9.4 The task is to identify what factors are likely to lead to coordination taking place between firms post-merger. This was a controversial area with which competition authorities and courts have struggled to come to terms over the years, but experience has led to the emergence of some agreement on what conditions are most likely to give rise to coordinated effects. These conditions are discussed below and their relevance depends on the type of coordination.

9.5 However, it must be borne in mind that these conditions are merely a starting point and that they must not be applied as a 'checklist'. The issue is whether the FTC can develop a coherent theory that takes into account all the evidence available and can explain (i) how the market works currently, and (ii) how the merger will make coordination more likely or stronger still (e.g., more widespread, or longer-lasting).

Assessing the competitive constraints

9.6 In order for coordination to be successful, three conditions must be met in the market or be created by a merger:

- First, the participants in the market must be able to identify terms of coordination, for example, the use of posted prices.

- Second, it must be costly for firms to deviate from coordination; so costly that it will be in each coordinating firm's interest to go along with the coordinated behaviour rather than 'cheat', e.g., through its own alternative pricing strategy. For these incentives to hold, participants may need to be able to detect and possibly 'punish' cheating; and

- Third, the surrounding competitive constraints must be weak. For example, the threat from players 'outside' the common strategy, including possible market entrants, must be too weak to destabilise any coordinated behaviour.

9.7 In what follows FTC considers each of these three conditions in turn. Determining whether each of these three conditions that are favourable to coordination may be expected to arise in a given case requires an assessment of the structure of the relevant market, its characteristics, and any history of coordination. Where a cartel has been detected in the relevant market in the past, this may serve as strong evidence that all three conditions are fulfilled, provided that market conditions have not changed significantly since.

First condition: identifying terms of coordination

9.8 In order to coordinate, firms need to achieve some kind of understanding as to how to do so. This need not involve an explicit agreement on what price to charge, market share quotas, or the quality of products to be attained. Nor is it necessary for the firms concerned to coordinate prices around the monopoly price, or for the coordination to involve every single firm in the market. However, it is sometimes possible for firms to find a 'focal' point around which to coordinate behaviour. Market transparency, product homogeneity, and stability of the relevant firms are key elements in giving the firms the ability to align on terms of coordination. But the relevant factors are highly dependent on market facts, how competition works in the market and how coordination would work.

Evidence

9.9 Examples of the **evidence** FTC will be taking into account when determining the extent to which firms are able to align behaviour in a given market includes the following:

- **Market transparency** – the more readily information on firms' competitive offerings (in particular, prices or which customers they serve) is available, the easier it will be for firms to align behaviour. If coordination takes the form of customer or market allocation, all that is required is to observe who supplies whom, which may be an easy task. Also, the smaller the number of firms the easier it will be for them to align with each other.

- **Product homogeneity** – the more homogenous products or services are on a given market – and the smaller the range of products – the easier it will be for firms to compare their competitors' offerings and price accordingly. If products are not homogenous, e.g., where each product/service is provided on an individually customised or 'bespoke' basis, or where many variables are taken into account in determining prices, it will be more difficult for firms to arrive at a common understanding. However, product homogeneity is not relevant when cooperative behaviour takes the form of customer allocation.

- **Existence of 'maverick' firms** – if one or more firms in the market are a ‘maverick firm’, coordination may be difficult to sustain. A maverick firm is a firm whose strategy is different from the majority of firms because of lower costs or other differences, but nevertheless is rational for itself. Alternately, if the maverick firm is one of the merging parties, then the likelihood of coordinated behaviour may rise because the merger eliminates the differences that led to maverick behaviour. In general, the more symmetrical are the cost structures of the firms in the market, the easier it may be for them to coordinate behaviour.

- **Cross-shareholding** – if a firm has equity participation in a competitor, the scope for collusion may be enhanced. Links between competitors can make it easier to coordinate pricing and marketing policies, or to exchange information on these matters. Also, incentives to compete might be reduced in such cases given that the financial performance of the firm is affected by the profits of the competitor in which the firm has participation.

<u>Second condition: costly for firms to deviate from coordinated behaviour</u>

9.10 Though coordination is in the collective interests of the group of coordinating firms, it is normally in firms' short-term individual interests to 'cheat' on the coordination by cutting price, increasing market share, or selling outside 'accepted' territories. If coordinated behaviour is to be maintained, any such 'cheating' must be in some way observable directly or indirectly. For coordination to be sustainable the market concerned should therefore be sufficiently transparent that firms can monitor the important terms of competition with a view to detecting cheating in a timely way and responding to it. Firms might have credible ways of 'punishing' any deviation from the coordination, for example, by rapidly cutting prices or expanding output. More generally, it may be sufficient for coordinated behaviour that participating firms have a strong incentive not to deviate from the coordinated behaviour (suc h as experience of a previous period of strong competition).

9.11 A competition authority seeking to assess how incentives are structured within a particular market will have to gain an in-depth understanding of the competitive interaction within the market in question in order to assess whether coordination would be sustainable. Often past behaviour and even anecdotal evidence will assist in building up this understanding.

<u>Evidence</u>

9.12 Notwithstanding these difficulties, it is possible to identify some evidence useful in assessing the applicability of this second condition concerning the stability of the coordination.

- **Market transparency** - In some forms of coordination, it is necessary for suppliers to obtain details of competitors' offerings. If such data is not readily available to the suppliers, it will be more difficult for firms to monitor one another's behaviour and ensure that coordination is maintained.

- **Market stability** - If overall and firm-level demand in a given market is stable and the market is mature, it will be relatively easy for firms to detect movements resulting from a change in competitive behaviour by another firm and respond accordingly. Information on past trends within a market, such as growth in sales, entry and exit by firms, and relative market shares will often provide a good starting point when assessing the current state of a market and its likely future development. Also, demand stability depends on the regularity and frequency of orders. An unexpected large order may give an incentive to firms to break the coordination while high frequency of orders helps firm to bring their behaviour into line because it will be easier for firms to detect changes in each others behaviour.

- **Cross-shareholding** – if a firm has equity participation in a competitor, or if they operate a joint venture, not only may the scope for collusion be enhanced as already seen for the first condition, but it may be more costly for a firm to deviate given that the financial performance of the firm is affected by the profits of the competitor in which the firm has participation.

- **Multi-market contacts and symmetry** – If the coordinating firms compete with each other in various markets, the potential to 'punish' deviation might increase. The more symmetric the firms are with regard to market shares, cost structures etc., the more symmetric their incentives and their mutual sanction potential are. Also, the threat of punishment may be credible in certain situations; for instance, where firms not only supply to the same customers but also deal with each other by way of sub-contracts, the termination of such contracts might present a threat to 'punish' deviation from the coordinated behaviour.

Third condition: weak competitive constraints

9.13 Overall, the conditions of competition in the market need to be conducive to coordination to sustain such behaviour. Typically, this means that the market should be sufficiently stable and with such limited competition (both actual and potential) that the coordination is not likely to be disrupted. For example, a strong fringe of smaller competitors with capacity to take sales from the coordinating firms (or perhaps a single maverick firm) or a strong buyer (with buyer power) might be enough to render coordination impossible or unsustainable. Low barriers to entry may also render coordination unsustainable.

Evidence

9.14 In order to determine whether coordinated behaviour in a given market would be sustainable, the following information is likely to be relevant:

9.15 Market shares of the participants. Is there a fringe of smaller competitors with sufficient spare capacity or a possible maverick competitor (not part of the merger)?

- Details of new entry, including evidence of past entry and likely ease of entry in the future. Could new entrants upset any coordination aimed at reducing overall capacity in the market?

- Details of buyers. Are there any powerful buyers? By concentrating its orders a powerful buyer might be able to break coordinated behaviour.[21]

9.16 It should be remembered that the analysis must not stop once the competition authority has concluded that a market has conditions that may facilitate coordination.

9.17 This in itself does not tell FTC that a merger will make coordination easier or more likely. A focus on the track record of each competitor in the market may help to determine what dynamic they bring to the market. The merger might be 'swallowing up' a maverick firm, making coordination more stable or durable, or it could even be creating a lower-cost firm whose incentive is to deviate from – and thereby frustrate –coordination. Perhaps third parties are the most important actors in the market and the merger itself makes no real difference.

9.18 Demonstrating an increased probability of coordination as result of a merger may be a difficult task. If pre-merger conditions appear to facilitate coordination, then the effect of the merger may be to make coordination more likely, more effective and more durable. It is much less likely that a merger creates conditions for coordination that did not previously exist. Investigation of coordinated effects, like that of unilateral effects, should also focus on the specific effect of the merger itself rather than only the state of pre-merger competition.

[21] However, there are instances where coordination may be sustainable even in the presence of large buyers: for example, if the coordinating firms – in case of output coordination - are able to subcontract their orders out to each other in order to maintain the stability of coordination.

10 Market entry and Expansion[22]

10.1 A merger that materially increases market concentration would not give rise to sustained anti-competitive effects if new firms would enter the market (or existing firms expand) and deter the merging parties (and others) from exploiting their position in the market. Entry into the market by new firms may prevent or counteract any attempt by the merging parties or their competitors to profit from the potential reduction in competition brought about by the merger.[23]

10.2 In this part of the guideline, FTC considers entry by new firms or expansion by existing firms as a result of the merger, i.e., entry or expansion involving significant sunk costs of entry and occurring within the foreseeable future (often called 'committed entry'). Entry by way of supply -side substitutability can be seen as a special case of entry, since it must occur quickly and without any significant sunk investment.

10.3 Furthermore, the market entry analysed in this guideline refers to entry that would occur as a result of the new market conditions generated by the merger if approved. In other words, where there is evidence of entry from new firms outside the relevant market (or exit from existing firms in the relevant market) or committed expansion plans by existing competitors that would occur absent the merger, this evidence should be reflected in the counterfactual. The competitive situation without the merger would be altered because of this entry, exit or expansion.

Economic rationale

10.4 It is common to think of the constraints on competitive conduct within a market arising only from firms already active in that market. This is the competitive constraint assessed by concentration measures of the sort described in part 7. However, it is possible that the constraints posed by firms outside the market might change in the near future as a result of the merger. When this is sufficiently likely to happen, the reviewing authority needs to take it into account in assessing the competitive effects of the merger.[24] The sorts of changes that a FTC might need to take into account include:

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[22] Annex 6. Case studies: Barriers to entry and expansion.

[23] As noted in market definition, it is also possible to assess shorter term supply-side responses in the context of market definition.

[24] This is of course one of the reasons why caution is needed with concentration measures of the sort discussed earlier. In brief, they provide only a 'snap-shot' of a market at a point in time, and so may not reflect the sorts of changes in competitive structure that are discussed in this guideline.

- An increase in the number of competitors active in the market because a new competitor enters the market (new entry);
- An existing competitor, already in the market, becomes a much more important competitor than before, e.g., because it builds new production capacity(expansion); or
- An existing competitor repositions an existing product (product repositioning).

10.5 New entry or expansion by competitors sometimes can effectively discipline the behaviour of the current market participants. Although FTC may adopt different approaches to determine the likelihood of new entry, FTC should only conclude that entry/expansion is a real competitive constraint on the merging parties where three conditions are met:

- The entry or expansion is likely to occur;
- The anticipated entry or expansion is of a nature, scale and scope to prevent or reverse the anticompetitive effects the merger otherwise would have; and
- The entry or expansion is likely to occur within a reasonable period of time (i.e., it should be timely).

10.6 This section describes how each of the above three conditions (often shortened to the likelihood, sufficiency and timeliness of entry) will be investigated and assessed by FTC. Each is considered in turn. In this discussion, the term 'entry' is used to refer to possible entry, expansion and repositioning, as the investigative considerations are similar for all three.

Likelihood of entry

10.7 Entry is likely to occur if it would be profitable. Thus, when reviewing a merger, a competition authority faces a number of critical issues:

- Would the merger itself trigger entry into the market? Indeed this might happen because of the effect of the merger on the profitability of entry.

- Would the proposed merger itself create a significant opportunity for entry?

10.8 To assess the probability of entry, it is useful to consider barriers to entry, as well as any history of entry or exit.

10.9 Are there any **barriers to entry** to the market (or markets) that might make entry unlikely? A barrier to entry can be described as an advantage enjoyed by an incumbent firm over potential entrants which prevent new firms from entering the market.[25]

10.10 The mere need to invest in order to enter is not of itself a barrier to entry. Rather, when assessing barriers to entry it is important to look at the expected profitability of entry in order to see whether they may be considered low or high. It is possible to categorize entry barriers in various ways. One such categorization is as follows:

- **Absolute barriers**[26], such as where government regulations, e.g., licensing and intellectual property rights, limit the market participation or impose substantial regulatory approval costs (e.g., environmental restrictions). Regulations can also make it more difficult for consumers to switch supplier.

- **Structural barriers**, arising from basic market conditions such as cost, demand and technology. Examples include situations where the existing incumbents control assets necessary for the production or supply of the relevant products (e.g. natural

[25] See also OECD Roundtable on 'Barriers to Entry', 2005.

[26] Some jurisdictions describe these as legal/regulatory advantages.

resources); where existing firms have access to a superior technology; where networks effects are strong; and where economies of scale and sunk costs are important. A merger would not attract entry if the anticipate reward were not commensurate with the risk from being unable to recover **sunk costs** (e.g., expenditures not recoverable upon exit, associated with acquiring or constructing specialized facilities, recruiting, training, product development and other requirements for successful entry).

- **Economies of scale** can limit the incentive to enter.[27]Even when investment costs are not sunk, scale economies tend to deter entry in the sense that only large-scale entry would be profitable. In this connection, information on the minimum viable scale needed to enter the market can provide an indication of the scale that a new entrant would need to make in order to compete profitably.

- **Strategic advantages**, where the existing established position of the incumbent gives it an advantage over new entrants (also known as 'first mover advantage') or where the incumbent responds to new entry with aggressive tactics such as by significantly lowering prices or by investing in excess capacity to deter entry. Two important aspects of this are sunk costs (e.g. expenditure in advertising and R&D) and reputation. Where demonstrated reliability is very important to the buyer, this can favour current suppliers. Other factors might include product differentiation, tying and bundling, and exclusive dealer agreements.

10.11 By comparing the costs of entry with the expected sales income (net of the operating costs) and how long it will take to recover incurred costs, it is possible to gauge whether potential entrants will consider that entry is profitable. It is also useful to ask customers whether they would be willing to switch to a new supplier as this will impact on how effectively new entry can be expected to constrain the merging parties' behaviour. The merging parties may be able to provide data on customer gains and losses to determine the level of customer switching in the market.

[27] Economies of scale enjoyed by incumbent firms arise where average costs fall as the level of output rises. Typically, this occurs when there are high fixed costs for the initial investment – say, a sizeable plant – which has relatively low running costs (i.e., variable or marginal costs). See also the OECD Glossary of Industrial Organization Economics and Competition Law (1993).

10.12 Is there a **history of entry** to (and exit from) this market? If it is possible to establish a record of firms entering and exiting the market, that can be sound evidence that entry into the market is possible and may continue.

- What have been the experiences of firms that have in recent years entered or exited from the market? If there is no evidence of any new firm having entered in recent years, a reviewing authority might be more cautious in relying on evidence about possible new entry. There might be barriers of a less obvious nature. Evidence from similar markets in other countries may be useful.

- As a complement, information about past and expected market growth may also be an indicator as to the likelihood of entry. Generally, in a market that has experienced recent growth which is expected to continue, new entry is more likely. In contrast, a shrinking market where suppliers face increasingly reduced margins can be expected to attract less new entry.

- A note of caution: a lack of entry does not necessarily mean that entry barriers are high. In fact, the cost to enter the market as such may be low but the market concerned is so competitive that entry is not attractive. Similarly, the mere need to invest in order to enter is not of itself a barrier to entry. On the other hand, the fact that past entry has occurred does not automatically mean entry barriers are low: entry may have been on small scale or into a specific market niche.

10.13 What might be highly relevant is evidence of firms currently contemplating entry but only if circumstances change. In this case, the merger may or may not be the sort of change in circumstances necessary to cause firms to enter.

10.14 Another factor to consider is whether there are large buyers that have in the past or might in the future 'sponsor' new entry, as this would also likely act as a constraint.

10.15 Furthermore, FTC will look at the duration, termination and renewal provisions of clauses in existing sale contracts. If, for example, buyers are tied into five year contracts, it could take a long time for an entrant to capture market share. This may reduce the profitability and consequently the likelihood of entry.

Sufficiency of entry

10.16 This condition generally requires that entry by new firms successfully prevents incumbents from raising price post merger or makes them promptly reverse price increases, by capturing a sufficient amount of their sales. Even profitable entry therefore may not be sufficient if it fails to win enough business from existing firms which could still extract increased profits through price rises. Small scale entry into a niche market might not be of sufficient scale to act as a constraint, although each case should be considered on its own facts. When analysing the sufficiency of new entry, therefore, the following questions should be considered:

- Is the new entry likely to be so small or isolated that incumbents can nevertheless still raise prices to a significant section of the market? It may be that the new entry is of insufficient scope to compete effectively with the merging parties.

- In a merger between sellers of differentiated products would the new entrant provide a product that competes directly with those of the merging parties such that a sufficient number of customers would switch to the entrant product in response to an attempt by the merging firms to raise prices by switching away?

- Is the new entry able to counteract the specific anticompetitive concern brought about by the merger?

- Is the new entry able to counteract any localised anticompetitive effects? In some cases, the anticompetitive effect(s) of the merger might only occur in a distinct location and any new entrants would have to target their business in the adversely affected area in order to prevent such effects.

Timeliness of entry

10.17 Profitable entry will only be considered to act as a competitive constraint if it is sufficiently timely and sustainable. Many jurisdictions consider that entry must occur within two years to have a disciplining effect.

Expansion

10.18 The ability of existing market participants to expand their capacity quickly, or utilize existing spare capacity, in response to a price rise by the merging parties can act as a competitive constraint. Many of the factors that are considered in the assessment of new entry are relevant to the analysis of expansion. Rival firms should be asked whether they have expansion plans, whether they face any barriers to expansion, and the level of costs to be incurred versus increased revenues to be gained.

11 Efficiencies[28]

11.1 A merger may deliver efficiencies. It could increase productive efficiency, and hence, benefits could be passed on to consumers, for example, in lower prices or increased innovation. In this part of the guideline, we discuss efficiencies claimed for horizontal mergers.

11.2 Efficiency gains are often claimed for horizontal mergers. However, efficiencies are not frequently supported with convincing evidence and consequently FTC will generally tend to be sceptical about such claims. So far there are very few cases where a horizontal merger enforcement decision has turned explicitly on the efficiency-enhancing attributes of the transaction. Of course, if scepticism is carried too far there is a risk that pro-competitive (or pro-consumer) mergers will be stopped. On the other hand, if expected efficiency gains do not materialize in cases where there are competition concerns, consumers will be harmed.

11.3 The quantification of merger-specific efficiencies is often the most speculative single element of merger review. Efficiencies are most likely to make a difference in merger analysis when the likely adverse competitive effects, absent the efficiencies, are small and when the degree of post-market power is not too high.

[28] Annex 7. Efficiencies: Case Studies

Economic rationale

11.4 Mergers can generate significant efficiencies by permitting a better utilisation of existing assets, enabling the combined firm to achieve lower costs than either firm could have achieved alone. Efficiencies may increase rivalry in the market so that no adverse competitive effects would result from a merger. For example, this could happen where two of the smaller firms in a market gain such efficiencies through merger that they can exert greater competitive pressure on larger competitors.

11.5 Efficiencies include cost savings, more intensive use of existing capacity, economies of scale or scope, or demand-side efficiencies such as increased network size or product quality. They might also encompass pro-competitive changes in the merged entity's incentives, for example by capturing complementarities in R&D activity, which in turn might increase incentives to invest in product development in innovation markets.

11.6 In a unilateral effects context, marginal cost reductions may offset the merged firm's incentive to elevate price. While efficiencies are typically more relevant for the assessment of unilateral effects, there are some situations where they might also play a role in the assessment of coordinated effects. In this context marginal cost reductions may make coordination less likely or effective by enhancing the incentive of a maverick to lower price or by engendering disharmony among competitors through increasing cost asymmetry.

Which efficiencies should be considered in merger review

11.6 Efficiencies tend to have an impact on short-term pricing behaviour incentives (in terms of lower prices for customers) if they lower the marginal or variable costs and there is sufficient competitive pressure remaining. Conversely, savings in fixed costs generally will not often impact short-term pricing behaviour incentives, so that fixed costs savings will normally not be passed on to consumers. It is often challenging to make a clear distinction between variable and fixed cost savings as this distinction will depend on the time horizon used. Also, fixed costs may be important in short run price formation where, for example, competition takes place via auctions and bids that reflect both the fixed and variable costs of the tendered service.

How to incorporate efficiencies in merger review

11.7 Another fundamental question is how efficiencies are incorporated into the assessment of individual cases. Efficiency evidence may be taken into account as part of the competitive effects analysis by showing that the economic incentives to compete of the merged firm may be increased so that the merger would not harm consumer welfare (e.g., will result in lower prices, improved quality or new products). This '*integrated*' approach looks at the net effect of a merger on prices (and other indicia of competitive performance) and is the approach favoured by FTC.

Assessment

11.8 Merger-specific efficiency gains are difficult to assess both for merging parties and for competition authorities. The merging parties typically have the best knowledge about the likely efficiencies that a merger may create for them. However, this self assessment might be too optimistic and has proven wrong for many mergers. Also, merging parties have a clear incentive to overstate the likely efficiencies when presenting them to the competition authority or courts. Claimed efficiency gains therefore have to satisfy a high evidentiary standard which the merging parties have to meet.

11.9 The **evidence** of the claimed efficiencies is normally solely in the possession of the merging parties. Such evidence may include internal documents that were used by the management to decide on the merger, statements from the management to the owners and financial markets about the expected efficiencies, historical examples of efficiencies and pre-merger external experts' studies on the type and size of efficiency gains. Where reasonably possible, efficiencies and resulting benefits should be quantified. In general, jurisdictions require that only those efficiencies which have a high probability of realization within a reasonably short period post merger will be taken into account. Assessing efficiencies is very difficult in practice.[29]

[29] In most jurisdictions the second requirement is that some share of the benefits expected to be realised from post merger efficiencies is likely to be **passed on to consumers** (or customers), usually in the form of lower prices or increased output, if they are to be taken into account in the merger review. The third requirement in most jurisdictions is that the efficiency gains are **merger specific**, or, in other words, not likely to be produced or available absent the merger. The verification of this requirement entails the specification and possible quantification of alternative scenarios, i.e., different forms of non-merger cooperation between the companies such as joint ventures. However, only practical business alternatives likely to be pursued absent the merger should be considered.

12 Failing Firm[30]

12.1 Where one of the parties to a merger is genuinely failing, pre-merger conditions of competition might not prevail even if the merger was prohibited. In these circumstances, the counterfactual would need to reflect the expected failure of one of the parties and any resulting loss of rivalry. But, the 'failing firm defence' may be claimed by merger parties even where a firm is not truly failing. Hence, claims that a firm is failing need to satisfy a high evidentiary standard.[31]

Economic rationale

12.2 A merger is not likely to create or enhance market power or to facilitate its exercise, if imminent failure of one of the merging firms would cause the assets of that firm to exit the relevant market. In such circumstances, the competitive structure after the merger may be no worse than the competitive structure had the merger been blocked. It should be noted that the counterfactual – with which the post-merger situation should be compared - is not the pre-merger situation, but the situation occurring after the failing firm would have exited the industry. The treatment should be the same in the highly unusual case where the failing firm is actually the acquiring firm.

12.3 Normally, economically viable assets are unlikely to exit the relevant market, while the acquisition of assets that are not economically viable would not be expected to remain in the market. The acquisition of a failing firm's assets, however, can cause its assets to become economically viable, and thus remain in the market, if the acquisition generates significant efficiencies.

Conditions

12.4 In order to satisfy the failing firm defence against a finding that a merger would be anti-competitive, conditions along the following lines should be met:

- First, in order to rely on a failing firm defence, it must be clear that the firm is in such a **deteriorated financial situation** that without the merger it and its assets would exit the market and this would occur in the near future.

[30] Annex 8. Failing firm: Case studies
[31] See also OECD Roundtable on 'Failing Firm Defence', 1996.

- Second, there must be **no serious prospect of re-organising the business**. This could include re-organising the underlying business or the financial structure. Identifying the appropriate counterfactual in these types of situations is often very difficult. Even companies in severe financial difficulties often survive and recover and, as explained, the test is whether in the absence of a merger, the assets of the failing firm would inevitably exit the market.

- Third, there should be **no less anti-competitive alternative to the merger**. Even if the company is failing and a sale of the company or its relevant assets is inevitable, the failing firm argument only applies where there are no competitively preferable acquirers of the assets. If an alternative firm is willing to acquire the assets, then it is unlikely that the assets would exit the relevant market without the proposed acquisition. An acquisition by such an alternative firm may be less anticompetitive than the proposed merger. It may also be better for competition that the firm fails and the remaining players compete for its share of the market and assets than that the failing firm's share and assets are transferred wholesale to a single purchaser.

12.5 In most cases, the acquisition of the failing firm can prevent its assets from exiting the market only if there are merger-specific efficiencies. Indeed, it is part of the competitive process that firms will fail, either because of internal problems or due to external changes in market demand and resultant excess capacity. In such circumstances mergers can be an effective means of putting resources to alternative uses and/or improving efficiency through rationalisation.

12.6 Merger review should not exclude the possibility that the acquisition of a failing firm, which initially raises competition concerns, can result in customer benefits. Indeed, the competitive outcome with the merger may be better than the competitive outcome without the merger (the counterfactual).

12.7 In most instances, the acquisition of a failing firm does not even raise competition issues because there are sufficient competitive constraints on the merged entity remaining in the market, even if the assets of the failing firm would still exit the market.

Evidence

12.8 Information to establish a failing firm defence may include the following evidence:

Deteriorated financial situation

- In most cases, the assistance of financial and accounting expertise will be required to detail the information necessary for a proper examination of the condition of the failing firm and to assess the merits of the claim.

- Historic financial information on the business that it is claimed is 'failing' should be sought, ideally profit and loss and cash flow information. This information includes the latest balance sheet and analysis of the most recent statutory accounts.

- Prospective financial information should also be requested including forecast information for the current year. More weight is likely to be given to forecasts produced either in advance of the transaction or for another purpose and not produced solely for the competition authority.

- In considering the financial situation of a division, care must be taken to ensure that the correct revenues and costs are considered. The division must have a negative cash flow on an operating basis.

- To establish that trading conditions and hence financial performance are unlikely to improve, it would be useful to consider whether the business is in an industry where cyclical losses are normal or whether the failure of the business may be the result of technological change.

Unable to re-organise successfully

- Evidence proving that the business is irredeemably failing might come from board papers or other strategy documents produced by the company considering various ways to improve the situation.

- It will be necessary to consider whether all re-financing options have been explored and exhausted.

No less anti -competitive alternative to the merger:

12.9 Evidence should be sought to establish that the failing firm unsuccessfully sought out less anticompetitive alternatives to the proposed transaction. That is, it must be shown that there are no other credible bidders in the market, and that all possible options have been explored. If there was an auction or similar process in which all logical potential acquirers were given an opportunity to participate, it may be possible to demonstrate that the vendor explored all options. If such process was not carried out, the competition authority may undertake an assessment of whether such firms are interested in acquiring the firm or its relevant assets.

13 Non-Horizontal Mergers

13.1 There are two broad types of non-horizontal mergers: vertical mergers and conglomerate mergers.

Vertical Mergers [32]

13.2 As explained in previous parts, vertical mergers are those between firms that operate at different but complementary levels in the chain of production and/or distribution of the same final product. Vertical mergers can potentially generate substantial efficiencies and should rarely be a cause for concern. In some cases, however, vertical mergers may give rise to competition issues. The vertically integrated merged entity may be able to constrain the ability of rivals to compete by excluding them from a market or by raising their costs; when such actions harm consumer welfare, they are anticompetitive. Furthermore, as a result of the vertical merger, the potential for price or output coordination may increase.

Economic rationale

13.3 Because a vertical merger is between parties that do not currently compete in the same relevant market, it does not have the direct anticompetitive effect of reducing the number of horizontal competitors. Moreover, vertical mergers have significant potential to create efficiencies and are rarely

[32] Annex 9. Vertical Mergers: Case studies

anti-competitive. Transactions costs associated with performing complementary activities may be best minimized by internalizing those activities as technology changes over time. The realization of the efficiencies from vertical mergers may be expected over time to reduce production and internal organizational costs and thereby allow more and higher quality products to be produced at lower cost to society.

13.4 In some situations, however, a detailed factual analysis may show that a proposed vertical merger is likely to have an anticompetitive effect in a particular market. If that is the case – and assuming that merger-specific efficiencies will not offset the harm to competition – it is appropriate for an enforcement authority to seek to enjoin the transaction. In deciding whether to challenge a proposed vertical merger, a competition authority should rely on a detailed, credible, and substantial factual basis supporting the conclusion that the merger will harm competition in a particular market.

13.5 Taking these caveats into account, there are situations under which a vertical merger may prove to have anticompetitive effects by enhancing market power of the merged entity or increasing the potential for price or output coordination.[33] These situations are analysed below and should be carefully assessed. In particular, evidence developed to show that a particular situation applies should lead to enforcement action only when the evidence indicates that the merger would likely lead to a diminution in consumer welfare.

Unilateral anticompetitive effects

13.6 A vertical merger can have anticompetitive effects if it enables the vertically integrated merged entity to constrain a rival's ability to compete either by foreclosing it from an upstream or downstream market or by raising its costs in a way that permits the merged entity to exercise market power.[34] The anticompetitive behaviour of the merged entity can increase rivals' costs and eventually this will lead

[33] In addition, a regulated firm may vertically integrate with a non-regulated (upstream or downstream) firm in the hope of subsequently "evading" price regulation by "leveraging" its monopoly from the regulated to the unregulated stage of commerce. (It may also reassign costs between stages of commerce.)

[34] The term 'foreclosure' is used in some jurisdictions to cover both the form of exclusion of rivals from a market and any other anticompetitive conduct such as raising rivals' costs or barriers to entry.

the rivals to raise their prices to consumers, thereby enabling the merged entity responsible for the rivals' cost increase to raise its prices as well.

13.7 For example, in certain limited market conditions, if the merged entity gains control, post-merger, of a critical means of competitive distribution to a downstream market, it might be able to reduce competition from its rivals by refusing to give them access to that means of distribution, or by granting access only at discriminatory prices that favour the merged entity's own business, thus placing rivals at a disadvantage. Or, if a merged entity gains control of a large proportion of a critical input to a downstream process where it also competes, it may be able to dampen competition from its rivals in the downstream market by, for instance, diverting all its production of the input to its own downstream process. If the merged entity thus refuses to supply a product to its downstream rivals, or only sells the input to its rivals at a price that makes them uncompetitive, this might also foreclose competition or allow it to increase prices to consumers.[35]

Increased potential for coordination

13.8 Under certain circumstances, a vertical merger can increase the likelihood of successful price or output coordination by altering incentives and abilities to collude within either the relevant upstream market or the relevant downstream market or both. Such concerns may arise, for example, where vertical integration increases market transparency, cross-ownership or multi-market contacts between firms in one or more key dimensions of competition (e.g., price, output, capacity, or quality) or decreases the likelihood of market entry. For example, if vertical integration affords the merged entity better knowledge of selling prices in another market together with other factors, anticompetitive coordination in that market might be facilitated.

13.9 A vertical merger will not facilitate price or output coordination in any relevant upstream or downstream market implicated by the merger – and, thus, will not be anticompetitive – unless, post-merger incumbents are able to (i) reach terms of coordination on some competitive dimension (e.g., price, output, capacity, or quality), and (ii) detect deviations from the coordination, and (iii) punish firms that deviate.[36] A merger may make coordinated conduct substantially more likely to occur by making it

[35] In particular there is the possibility that a vertical merger might alter incentives so as to make refusal to supply – or worsening the terms of supply – more credible than pre -merger, to the detriment of competition and ultimately of consumers.

[36] For example, a vertical merger taking place in the presence of an already vertically integrated incumbent might increase cost transparency between the new integrated firm and the integrated incumbent. Similarly, to the extent that a vertical merger would increase transparency in

easier for firms to meet one or more of these necessary conditions. Even assuming those conditions are satisfied; enforcement action should only proceed if the evidence indicates that anticompetitive coordination would likely occur.

Assessment

Unilateral anticompetitive effects

13.10 In assessing the possible anticompetitive effects of a vertical merger it is important to consider the following:

- First, it is necessary to check whether or not the integrated merging firm would have the **ability** to exercise market power in the upstream and/or downstream market to foreclose rivals or raise their costs in a way that harms consumer welfare. Evidence with regard the upstream market could include, for example, the demand elasticity for the input (i.e., are inputs sold by the other upstream firms close substitutes?); whether or not upstream rivals have excess capacity (could they expand their supplies, for instance, in the case where the integrated merging firm refuses to supply the independent downstream firms?); and the existence of potential entry. These factors might reduce the ability of the merged firm to exercise market power in the upstream market. This is a similar analysis as for a horizontal merger situation to see whether the merging firm is able to sell at higher prices (or cease to supply) the input to the downstream firms in a non transitory and profitable way. At downstream level, a similar analysis should also be carried out.

- Second, even if the merged entity has the ability to foreclose rivals or to raise their costs, it is important to consider the **incentives** of the merged firm to engage in this conduct in any market. Thus, evidence should focus on whether and to what extent the merger would actually enhance the incentives to act in a way that is detrimental to consumers. In certain cases, the merged firm may have the ability to engage in anticompetitive practices in some way, but lack the incentive to do so as such a strategy would not be profitable. As previously emphasized, a vertical merger

any of the key dimensions of competition (e.g., better enabling a seller to know that it lost a sale to competitor because of a lower price), the ability and incentive to achieve successful anticompetitive coordination may be enhanced.

should not be challenged absent evidence supporting all elements of the theory of anticompetitive harm.

- Finally, an analysis should be carried out to check whether or not consumers (or customers) are harmed as a result of the transaction. In particular, any efficiency claims of the vertical merger should be taken into account.

Increased potential for coordination

13.11 Will the merger affect the scope for alignment, market transparency, monitoring of adherence to the coordinated strategy, incentives not to deviate from that strategy, and competitive conditions conducive to coordination? The analysis, moreover, should focus not only on the potential for coordination (which may exist even pre-merger) but also on whether the merger increases the likelihood of coordination in any of the post-merger relevant markets. Absent evidentiary showing of an increased likelihood of coordination, an enforcement action is inappropriate.

Countervailing factors

13.12 As with horizontal mergers, a vertical merger that enables a firm to achieve or enhance market power may nonetheless produce substantial efficiencies. When these efficiencies are properly accounted for in the competitive effects analysis, the merger may be competitively neutral, if not pro-competitive, in so far as consumer welfare is concerned.

Conglomerate Mergers[37]

13.13 Conglomerate mergers also involve firms that operate in different product markets but without a vertical relationship. In practice, the focus is on mergers between companies that are active in related or neighbouring markets, e.g., mergers involving suppliers of complementary products or of products belonging to a range of products that is generally sold to the same set of customers.

13.14 Unlike horizontal mergers, conglomerate mergers do not entail the loss of direct competition between the merging firms in the same relevant market. A further characteristic of conglomerate mergers is that there is often a potential for efficiency gains when the products of the companies involved are complementary to each other. Therefore, conglomerate mergers normally do not harm

[37] Annex 10. Conglomerate mergers: Case studies

consumers. However, in rare circumstances, such mergers may raise competition concerns of foreclosure, or possibly, facilitating collusion.

13.15 In conglomerate mergers, as well with horizontal or vertical mergers, intervention requires FTC to make predictions about future developments of the markets concerned and of behaviours of the merging parties. These predictions are typically much more difficult with respect to conglomerate mergers than with respect to horizontal or vertical mergers. For this reason, some enforcement agencies prefer to use their ex-post powers to constrain abusive practices, instead of ex-ante merger powers, for any competitive concerns associated with a conglomerate merger. In their view, the risk that challenging a merger could result in consumer harm is significantly greater for conglomerate than for horizontal mergers and even vertical mergers. However, some other competition agencies believe it might be more efficient to prevent possible anticompetitive concerns under merger control powers in order to avoid the need for ongoing ex-post intervention and use of monopoly powers.

13.16 In terms of **unilateral** conglomerate theories of competitive harm, those agencies who believe ex ante control is warranted argue that in settings where the merger brings together strong market positions in individual markets, the new firm may be able to strengthen its market positions by means of tying or bundling. The main competitive concern in this context is foreclosure: as a result of tying or bundling, demand for competing rivals' products may be curtailed, as a result of which these rivals become less effective competitors in the longer run.[38] Foreclosure may be inspired by the desire to gain market power in the tied goods market, to protect market power in the tying goods market, or a combination of the two.

13.17 However, such conduct is likely to result in adverse effects on competition only if it would be difficult for rivals or new entrants to provide competing bundles and if they would therefore be unable to constrain the behaviour of the merged entity which could then engage in profitable price increases, output reductions or other strategies. As with assessing vertical mergers, it is important to consider first the ability and second the incentives of the merged firm to foreclose competition in any market. Finally, a careful analysis, which among other things considers any efficiency claims, should be conducted to determine whether consumers are likely to be harmed as a result of the transaction.

[38] See also the OECD Roundtable on 'Portfolio Effects in Conglomerate Mergers' (2002).

13.18 As far as **coordinated** effects are concerned, conglomerate mergers may facilitate coordination especially if the merged firm’s rivals in one market are also rivals in at least one of its other markets and if other factors facilitating collusion are also present in these markets.

13.19 The theory of competitive harm to consumer welfare in non-horizontal mergers needs to be substantiated by convincing evidence particularly given the fact that there is no loss of direct competition between the merging parties in the same relevant market.

14. Annexes

Annex 1

BOX 1 – Product Market Definition: Case Studies

Dairy Farmers / SODIAAL (2000)

The US Department of Justice (DOJ) challenged the proposed acquisition by Dairy Farmers of America, Inc. of SODIAAL North America Corp. on the basis of likely anticompetitive effects in the sale of 'branded stick and whipped butter in the Philadelphia and New York metropolitan areas.' The Department concluded that consumers of branded butter in these metropolitan areas so preferred it over private -label (store brand) butter, as well as margarine and other substitutes, that a hypothetical monopolist over just branded butter in each of those areas would raise price significantly. This conclusion was supported by econometric evidence, derived from data collected from supermarkets, on the elasticity of demand for branded butter in Phila delphia and New York.

Pierre & Vacances / Maeva (2001)

In the case Pierre & Vacances / Maeva, the French Minister for the Economy adopted a conditional clearance decision in respect of the transaction involving Pierre & Vacances' acquisition of a competitor, Maeva. The Minister defined the relevant product market as the market for homogenous furnished residences ('résidences meublées homogènes'), both parties' principal line of business. Demand-side substitution was analysed utilising a SSNIP -test in order to assess whether customers could and would switch to other products (in particular hotels) in response to a price increase. In response to a request for information from the DGCCRF, Pierre & Vacances, as well as one of its competitors, had submitted surveys containing SSNIP -studies.

In the first survey, conducted on behalf of Pierre & Vacances, consumers had been asked what their reaction would be in the event of a 10% increase of Pierre & Vacances' residences prices: 45% of the respondents replied that they would then give up Pierre & Vacances' residences. This ratio was rather high, but according to the Minister the result should be viewed cautiously, since the clients could have had incentives to reply that they would leave when asked by Pierre & Vaca nces how they would react in the event of a price increase. The second survey, submitted by a competitor, suggested that a 10% price increase in the homogenous furnished residences sector would indeed be profitable. Having considered the reliability of the two surveys, as well as other evidence, the Minister concluded that homogenous furnished residences constituted a distinct relevant product market.

Annex 2

BOX 2 – Geographic Market Definition: Case Studies

Compañia Industrial de Parras, S.A. de C.V., with Textiles Kamel Nacif S.A.de C.V., and Inmuebles Kamel, S.A. de C.V. (1994)

In 1994, the Federal Competition Commission of Mexico (FCC) analysed the acquisition by Grupo Parras, a company which had a major share in national denim production, of one of its strongest competitors.

To identify the relevant market affected by the merger, the Federal Competition Commission (FCC) of Mexico analysed the wide variety of weights and qualities of denim. The Commission concluded that the concentration would affect the market of high quality denim, in which the buyer would account for 100% of total domestic production.

The FCC studied import conditions, concluding that Argentina, Colombia, the United States of America, Hong Kong and Uruguay supplied denim to Mexico, and could all be regarded as feasible alternative sources of supply, for several reasons. First, denim import duties were relatively low; in the case of the United States of America, they were reduced to zero as a result of the North American Free Trade Agreement. Second, these countries had an abundant supply of denim for export, as they all had major export producers. Third, prices offered by these countries were below those offered by domestic producers. Finally, transport costs were relatively low, at less than 3%r of the aggregate product value.

The foregoing arguments prompted the Commission to consider both present and potential imports as elements which would limit substantially the likelihood that the merger, though resulting in high market concentration, would give the resulting company substantial power in the high quality denim market. This did not eliminate the possibility of merger induced price increases, but it did imply that these changes would be small and transitory, most likely for less than one year.

Granarolo / Centrale del latte di Vicenza (2001)

The Italian Antitrust Authority prohibited a concentration affecting the dairy sector in its *Granarolo / Centrale del latte di Vicenza* decision. The Authority found that the transaction would have given rise to anticompetitive coordinated effects on the market for the sale of fresh milk in the Veneto region in Italy.

The Authority defined the relevant product market with reference to differences in perishability rates, taste and nutritional qualities between fresh and long-life ('UHT') milk. These product characteristics also influenced the definition of the relevant geographic markets. In order to ensure an adequate shelf-life of the product, producers distributed the milk within a few hours of bottling. Moreover, the legislative framework mandated a sell-by date of no more than four days from the date of bottling. These factors placed constraints upon producers to disperse fresh milk within a radius of a few hundred kilometres from the different production sites. The geographic markets were found to be regional in scope. The Authority found that the need for companies to rely on an established local presence, in particular by owning trademarks which were renowned locally, contributed to this finding. The Authority found that this was confirmed by the largest competitors' strategies: producers operating on a national basis preferred to acquire local producers (and to adopt a co -branding strategy, using their own brand in combination with the local one) rather than competing against them using their own, nationwide, trademarks.

Annex 3

BOX 3 – Use of Concentration Measures – Cases Studies

Interstate Bakeries / Continental (1995)

The US Department of Justice challenged Interstate Bakeries Corp.'s purchase of Continental Baking Co., alleging that the purchase likely would have produced significant price increases for white pan bread in five major metropolitan areas. The Department considers several alternative bases for assigning market shares and measuring concentration. The Department did not assign shares on the basis of productive capacity because white pan bread was a highly differenti ated product and therefore the ability to sell the product was not congruent with the ability to produce it. The Department therefore concluded that a measure of actual retail sales was the proper basis for assigning shares. Assigning shares on the basis of the number of loaves sold was problematic because several different sizes of loaves were sold. Ultimately, the Department assigned shares both on the basis of pounds of bread sold and dollars of retail sales thereby generated. The merging firm's shares were significantly larger when assigned on the basis of revenue rather than weight, but they were substantial either way.

Gencor / Lonrho (1996)

This case concerned the proposed merger of the platinum activities of Gencor and Lonrho and the main issue analysed by the European Commission was the likelihood of coordinated effects. However this merger is also interesting because it involved a market where production is limited by a crucial input and thus existing reserves are more informative than market shares. In fact, for the purpose of competition analysis, it would be meaningless to report that a certain firm has (or had), say, a 20% market share if its reserves will be completely exhausted in a short time period: since the future market share of the firm is going to be nil, this firm will not exercise any competitive constraints on its rivals.

In the merger in question, the EC considered the market shares based not only on the actual production of platinum but also on the reserves. In 1995, the main suppliers in the relevant world-wide market of platinum were three companies (Gencor, Lenrho and Amplats) and Russia. The estimated combined market share of the parties was less than 35%. However, the merger would have reduced the number of companies controlling platinum reserves in South Africa (accounting for about 90% of world reserves at the time) from three to two. Together these two firms would have accounted for about 70% of world supply. Supply from other sources, including Russia, was fragmented.

<u>Annex 4</u>

BOX 4 - Unilateral effects: Case Studies

Kimberly-Clark / Scott (1995)

Kimberly-Clark Corp. and Scott Paper Co. were two of the leading US producers of consumer paper products when they announced their intention to merge. In facial tissue, Kimberly-Clark and Scott, together with Procter & Gamble, accounted for nearly 90% of all sales, and Kimberly-Clark's Kleenex brand itself accounted for over half of sales. By estimating the relevant demand elasticities using scanner data, the US Department of Justice determined that Scott's facial tissue products imposed a significant constraint on Kimberly-Clark's prices. Likewise, in baby wipes, in which Kimberly-Clark and Scott's brands together accounted for approximately 5 6% of sales, the Department's analysis indicated that each was the other's most significant competitive constraint. Hence, the Department concluded that acquiring Scott's facial tissue and baby wipes businesses likely would give KimberlyClark an incentive to increase prices significantly for the merging brands. The Department therefore challenged the proposed merger.

Volvo / Scania (2000)

Unilateral effects analysis was at the heart of the EC case Volvo/Scania (2000). This merger case concerned the acquisition of truck producer Scania by Volvo. The merger would have led to very high combined market shares (over 50%) in a number of Northern European countries. The market investigation also showed that in these countries Volvo and Scania were each other's closest competitors, pursuing similar strategies and with a very similar brand image. The European Commission observed in this respect that variations in the market share of one merging firm typically corresponded to a variation in the opposite direction of the market share of the other merging firm. On this basis, the Commission concluded that the proposed concentration would remove Scania and Volvo as each other's main source of competitive pressure from the market, thereby leading to increased prices i n the market for heavy trucks.

Annex 5

BOX 5 – Coordinated Effects: Case Studies

DS Smith / Linpac (2004)

DS Smith, a producer of packaging, acquired Linpac, also a producer of packaging. As a result of the merger the number of major corrugated cardboard sheet (sheet) suppliers in the UK was reduced from six to five. The market was relatively concentrated, with the five main suppliers having a share of approximately 75% of the market between them. The merger was referred to the UK Competition

Commission amid concerns that coordinated effects might result in a substantial lessening of competition as a consequence of the merger.
In assessing the likelihood of coordinated effects in the sheet market the Commission found that competitors would have been able effectively to monitor one another's competitive behaviour as a result notably of highly transparent price announcements. The Commission also found that it would be costly for firms to deviate from coordinated behaviour since other suppliers would be able to retaliate by increasing output and adjust their prices in response to any such deviation.
However, the Commission also noted that coordinated effects were only sustainable where competitive constraints from outside the group of major suppliers were weak. Following a detailed investigation, the Commission found that, despite some barriers to entry and expansion, the incentives and ability of current and future competitors to jeopardise the results of any coordination appeared to be significant. The existence of a number of fringe players and potential entrants into the market would undermine any coordination between the five main undertakings present on the market. The merger was therefore allowed to proceed.

South African Banks / Compcorp (2004)

The four major South African banks - ABSA, First Rand, Nedcor and Standard Bank - sought approval for the establishment of an industry-wide switch for the electronic submission of mortgage bond applications through a company call Comcorp. All mortgage applications by the banks would have to be submitted via a single channel, being the switch. The banks also intended to acquire the BondTrak software used by mortgage originators in managing their processes.
The Commission found that the joint control of the four banks over Comcorp would create a platform for co-ordinated conduct likely to lessen inter-bank competition as all four banks are involved in the broad financial services market, including the market for the provision of home loan financing.
The Commission found that through the formation of Compcorp, the banks would be able to jointly fix a transaction fee, which would require each originator to pay for the electronic submission of mortgage applications. The Commission found that this would have the effect of limiting the multiple submissions of mortgage applications to competing banks, wherein the mortgage originators play one bank off against the other in an effort to obtain the best interest rate for the consumer. A restriction on this process would severely harm the consumer in that inter-bank competition would diminish. The Commission was further of the view that the banks would be able to use Compcorp as a conduit to jointly fix prices and trading conditions and that this in turn would prevent innovation and limit competition amongst originators and ve ndors. Anti -competitive vertical effects arising from the transaction were also raised. The Commission therefore found that the merger would substantially prevent and lessen competition in the home loan application, home loan software and the home loan finance markets.
While the parties did put forward efficiencies, the Commission found that these could be attained outside the merger and that these efficiencies did not outweigh the anticompetitive effects arising from the merger. In addition, there were no public interest considerations that could justify approving this otherwise anticompetitive merger. The merger was prohibited.

Annex 6

BOX 6 – Barriers to Entry and Expansion: Case Studies

Mitsui Chemical / Sumitomo Chemical (2002)

The Fair Trade Commission of Japan (JFTC) cleared the proposed merger of Mitsui Chemical and Sumitomo Chemical. While remedies were required in certain markets, JFTC concluded that there would not be any antitrust concern on the ethylene propylene diene methylene (EPDM) market, while the merged firm would have market share of 50% of the relevant market post merger. JFTC's reasons included possible new entry and expansion of the existing competitors, particularly imports from overseas. The factors JFTC emphasized with regard to entry/expansion include, expanded production capacity of overseas EPDM manufacturers, easy and low cost transportation, and likelihood of customer reactions to switch suppliers and the trend of change of customers preference to the grades of product coming from overseas.

Genus plc / Supersires Ltd (2004)

This merger would bring together the two largest suppliers of professional artificial insemination services in Great Britain with a combined share of supply of 80-90%. However, the merger was not expected substantially to lessen competition in the market in part because barriers to entry were considered to be low. Some third parties argued that the presence of Genus was of itself the main barrier to entry as its operations were of a sufficient size to enable it to offer prices below those of any new entrant. The UK Office of Fair Trading (OFT), however, found a history of entry into the market with new entrants winning business from Genus when it was the monopoly supplier, as well as entry in the two years prior to the merger, and evidence of future planned entry.

Grafton / Heiton (2005)

In the acquisition of Heiton Group plc by Grafton Group plc, the parties overlapped in two main distinct relevant markets: supply of 'do-it-yourself' ('DIY') products and supply of building materials. The Irish Competition Authority found substantial evidence of entry in the two markets in the past, both from chain and independent stores. It was also very important to consider the expansion plans by the existing suppliers, although these plans were made independently of the proposed merger. In an industry that has been growing very fast in the recent years, the Authority observed that market characteristics pointed to low barriers to entry: low switching costs for customers and low set-up costs. The competitors who declared their intentions to expand were considered by the Authority wellplaced to enter not only those geographic markets where the merged entity would be a monopolist, but also markets where it is present in general.

<u>Annex 7</u>

BOX 7 – Efficiencies: Case studies

Office Depot / Guilbert (2003) (*)

In the clearance of the Office Depot/Guilbert merger, the European Commission noted that "Office Depot has identified a number of cost-reducing synergies that it expects will be generated by the proposed transaction. Office Depot submits that they are merger-specific, substantial, timely and verifiable, and they will benefit consumers of office supplies in both price and non-price terms. As such, they are put forward as pro-competitive efficiencies generated by the proposed transaction.

According to Office Depot, many of these projected savings can be realised without significant investments and will reduce the combined firm's variable costs, for example through savings in purchasing costs, packaging costs and freight costs." But since the European Commission did not find that the merger would reduce competition, it was not necessary to assess the claims by the parties. (*)The EC has not yet had cases where efficiencies were relevant for clearing a merger.

DirecTV / Dish Network (2002)

DirecTV Enterprises Inc. was owned by Hughes Electronics Corp. DirecTV operated one of two direct satellite broadcast (DBS) services in the United States. EchoStar Communications Corp., which operated the other DBS service, proposed to acquire Hughes. Economists working for the parties and economists in the US Department of Justice both engaged in extensive modelling of the competition between the two DBS services and with cable television operators with which the DBS services competed in providing "multi -channel video programming distribution." The Department concluded that this modelling supported the conclusion that the a cquisition would substantially harm consumers and filed suit to prevent its consummation. The Department's modelling indicated that efficiencies claimed by the parties would be insufficient to prevent the merger from creating significant anticompetitive effects.

Superior Propane / ICG (2000)

This case is an example of how a formal 'efficiency defence' - as described in paragraph F.10 – is applied. In the Superior Propane case, the Canadian Competition Tribunal allowed a merger of propane distribution companies that resulted in a monopoly in many local markets and which was found to lead to a significant and sustained increase in prices. The Competition Tribunal applied the Canadian efficiencies defence and found that, regardless of the anticompetitive price increase resulting from the merger, the efficiencies were so substantial that these efficiencies outweighed and offset the merger's likely anticompetitive effects. On appeal, the Canadian Federal Court of Appeal overturned the Competition Tribunal decision because the Tribunal did not assess the welfare implications of the 'wealth transfer' from consumers to producers which would result from higher prices. On redetermination, the Competition Tribunal affirmed its earlier decision, as it found that the efficiency gains were significantly higher than the sum of merger's anticompetitive effects and the socially adverse portion of the wealth transfer. The Canadian Federal Court of Appeal affirmed the Competition Tribunal's redetermination decision and the merger was allowed to proceed.

Annex 8

BOX 8 - Failing Firm: Case studies

Meade / Celestron (1990)

Meade Instruments Corporation (Meade) manufactured Schmidt-Cassegrain telescopes (SCTs). Meade's owner, Harbour Group Investments, proposed to merge Meade with Celestron International, also a SCT manufacturer, through a 50-50 joint venture with Diethelm Holding, Celestron's owner. Meade claimed, absent the merger, its business would fail.

The Federal Trade Commission (FTC) challenged the merger, and requested a US District Court to enjoin the partie s from consummating it. The decisive issue for the Court was whether the merging parties met their burden of proof to sustain the 'failing firm' defense.

The Court stated that Habour Group failed to meet its burden to demonstrate that the proposed merger with Celestron was the only available alternative for Meade. The Court noted in particular that the merger agreement had already been made before any serious efforts to find alternative purchasers had begun. Discussions between the parties leading to the merger took about five months, but only one week before the merger agreement was signed did Harbour Group first contact a brokerage firm to search for alternative purchasers. Evidence presented to the Court revealed that the broker's efforts were minimal: they were not conducted by the division with appropriate expertise, very brief offer materials were prepared, and few telephone inquiries were made with little follow up by the brokers responsible for the search. By contrast, the FTC presented evidence (i) of three other potential purchasers and (ii) that Celestron was concerned that if it did not acquire Meade, another company - in particular, a potential competitor - might acquire Meade. The Court stated that: "The FTC is not obligated to prove that these companies are immediately ready and willing to purchase Meade. Instead, it is Habour Group's burden to show that the Meade -Celestron joint venture is the 'only' available alternative."

Annex 9

BOX 9 - Vertical Mergers: Case studies

United States of America v. Premdor Inc. and Masonite Corp Premdor Inc (2001)

Masonite, the second -largest US manufacturer, and the primary supplier in the merchant market, of 'interior molded door-skins' a critical input into the manufacture of doors) was the target of an acquisition by Premdor, the second -largest manufacture of ' interior molded doors', and a small but significant participant in the upstream market through a joint venture. The DOJ's concern was that vertical integration between these two firms would facilitate coordination with their primary rival, the leading firm in both markets, which was already vertically integrated. That coordination would be facilitated (a) in the upstream market, where coordination between Masonite and the leading firm could be frustrated if an independent Premdor responded by expanding its output of doorskins, (b) in the downstream door market, where coordination between Premdor and the leading firm could be frustrated if an independent Masonite expanded its sales of doorskins to smaller, independent door manufacturers, (c) in both markets, b y more closely aligning the cost structures of the new merged firm and the leading firm, and (d) in both markets, by eliminating information asymmetries. The DOJ required divestiture of a doorskin plant as a remedy.

E.ON / Stadtwerke Lübeck (2003)

The German Bundeskartellamt prohibited E.ON, a large energy grid company, to acquire a 49,9 per cent share in the local municipal utility Stadtwerke Lübeck GmbH. According to the Bundeskartellamt's findings, the planned concentration would have resulted in a strengthening of dominant positions in both the national and local markets for electricity and gas sales. The markets affected were those for the supply of electricity to electricity distributors, to major and to small electricity customers as well as the market for the supply of gas to major gas customers. The vertical integration would have further foreclosed the markets affected and would thus have increased the companies' scope for action, i.e. their leeway for raising prices, to the detriment of consumers.

Patrick Corporation Ltd / FCL Interstate Transport Services Pty Ltd (2005)

In this case the Australian Competition and Consumer Commission investigated the proposed acquisition by Patrick Corporation (a publicly listed transport logistics company with a range of interests, including a 50 per cent shareholding in Pacific National, Australia's largest rail operator) of FCL is a large freight forwarding company whose principal business is freight forwarding with an emphasis on rail freight forwarding . The ACCC decided to oppose the proposed acquisition on the basis that:

- There would be a substantial lessening of competition in the market for the provision of Australia - wide rail freight forwarding services through foreclosure of the merged entity's freight forwarding rivals. The ACCC considered it likely that the proposed acquisition would increase Pacific National's ability and incentive to raise prices or otherwise discriminate against independent freight forwarders through the exercise of operational discretion in relation to train slot allocation practices and service pricing.
- There would be a substantial lessening of competition due to the raising of entry barriers in the market for east-west rail line -haul of non-bulk freight. The proposed acq uisition would also make it significantly more difficult for rival rail line-haul operators to enter this market in direct competition with Pacific National.

Annex 10

BOX 10 – Conglomerate Mergers: Case studies

GE / Honeywell (2001-2005)

In December 2005, the European Court of First Instance (CFI) upheld the European Commission's decision of July 2001 to block the merger of General Electric and Honeywell.
The Court did not annul the EC decision but it held that Commission made errors in relation to various aspects of the case, in particular in its analysis of conglomerate effects.
The CFI upheld the EC's findings concerning the horizontal effects of the merger. However, the CFI said the EC theories of conglomerate effects were not sufficiently established and proved.
The first theory concerned the conglomerate effects resulting from the merger owing to GE's financial strength and vertical integration. The Commission concluded that, post-merger, GE would have extended to Honeywell's markets its practices on the market for large commercial jet aircraft, by which it used its financial and commercial strength derived from its subsidiaries. The Court held that the Commission did not adequately establish that those practices, assuming that they had been put into

effect, would have been like ly to create dominant positions on the various avionics and non-a vionics markets concerned.

With respect to the conglomerate effects resulting from bundled sales of GE's engines with Honeywell's avionics and non-avionics products, the Court said that, in absence of the actual bundled sales, the fact that the merged entity would have had a wider range of products than its competitors was not sufficient to establish the dominant positions would have been created or strengthened for it on the different markets concerned. The EC had not established, on the basis of sufficiently strong economic evidence or on the basis of internal company documents, that the merged entity would have had the incentive to start offering bundled products.

Springer / ProSiebenSat.1 (2006)

The German Bundeskartellamt prohibited in January 2006 the proposed conglomerate merger between the two media companies Axel Springer AG ("Springer") and ProSiebenSat.1 Media AG ("ProSiebenSat.1"). Springer held dominant positions in German newspaper markets in which ProSiebenSat.1 was not active, and conversely ProSiebenSat.1 held a dominant position in the German TV advertising market in which Springer was not active. However, the merger would have strengthened the respective dominant positions in both newspaper and TV markets.

With its newspaper BILD, Springer held a market share of approx. 80 % in the national reader market for over-the -counter newspapers. The merger would have enabled Springer to further secure and strengthen BILD's position through cross-media promotional and editorial measures (cross-media promotion). As far as the national advertising market for newspapers is concerned, the merger would have enabled Springer to offer from one source coordinated product advertising campaigns in several media and to launch cross-media advertising campaigns for third parties.

ProSiebenSat.1 and the Bertelsmann group together held a dominant position in the TV advertising market with a constant market share of approx. 40 % each over the last ye ars (duopoly dominance). The merger would have lead to a further assimilation of the corporate structures of the two groups in the neighbouring markets for newspapers and magazines and would have resulted in a number of interlocks between Springer/ProSiebenSat.1 and Bertelsmann. This would have further secured and strengthened the duopoly, thus leading to coordinated effects. Also, unilateral effects were likely, as with the merger the newspaper BILD would have lost its substitute function as currently the only economic alternative to national TV advertising for advertising customers.

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