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In this issue:

Editorial.

Welcome to the latest issue of Compecon's Competition and Regulatory Economics EZine. The E-Zine provides regular updates on economic aspects of competition and regulation. In this issue we consider the announcement by the UK Office of Fair Trading that it intends to investigation Ryanair's minority shareholding in Aer Lingus. This represents the latest episode in a long drawn out saga. Our second article reports on the UK Appeal Court judgment which upheld the Competition Commission's decision that the British Airports Authority would have to dispose of its interest in Gatwick, Stansted and either Edinburgh or Glasgow Airports. The Commission's decision had been overturned by the Competition Appeals Tribunal on the grounds of apparent bias by a member of the Commission panel responsible for the airports inquiry. Our third article looks at the new US Horizontal Merger Guidelines which were published last August and which represent the first major revision of the Guidelines for 18 years.

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OFT Investigation of Ryanair's Aer Lingus Shareholding Not Surprising.

1. Introduction.

On 29th October, the UK Office of Fair Trading (OFT) announced its intention to investigate Ryanair's 29.82% shareholding in Aer Lingus. The announcement follows the EU General Court judgment on 6th July which:

1. Upheld the EU Commission's decision prohibiting Ryanair's proposed acquisition of Aer Lingus; and
2. Upheld the Commission's decision not to require Ryanair to dispose of its shareholding in Aer Lingus.

News media reports suggested that the OFT decision had come as something of a surprise. Arguably it should not have been. The EU General Court explicitly stated that its judgment "was without prejudice to the Member States' powers to apply, if necessary, their national legislation on competition to Ryanair's acquisition of a minority shareholding in Aer Lingus." (Para 19) A report prepared for the OFT and published last March concluded that a minority shareholding by a firm in a competitor was likely to be anti-competitive. More generally competition agencies in a number of jurisdictions have been considering the competition implications of minority shareholdings and this issue is addressed in the new US Horizontal Merger Guidelines published last August which are considered below.

2. Background.

Following the privatisation of Aer Lingus in 2006, Ryanair acquired a 19.16% shareholding in its main Irish rival. Ryanair then launched a formal public bid for the entire share capital of Aer Lingus. It notified the EU Commission of the proposed takeover, in accordance with the Merger Regulation. On 27th June 2007, the Commission adopted a decision declaring that Ryanair's planned takeover of Aer Lingus was incompatible with the common market. Ryanair then appealed the Commission decision.

During the Commission procedure Aer Lingus requested the Commission to order Ryanair to divest all of its shares in Aer Lingus. In a decision dated 11th October 2007, the Commission refused to grant that request, stating that it was not in its power under the Merger Regulation to order Ryanair to divest its shareholding since the planned takeover had not been implemented and Ryanair only held a minority shareholding which did not enable it to exercise control over Aer Lingus. By this stage Ryanair had increased its shareholding to 29.3%.

That decision was appealed by Aer Lingus.

In its appeal Ryanair argued that the Commission had made manifest errors of assessment regarding:

1. The competitive relationship between Ryanair and Aer Lingus;
2. Barriers to entry;
3. Route-by-route analysis;
4. Efficiencies; and
5. Commitments offered by Ryanair to offset any competition concerns.

The General Court dismissed all of Ryanair's arguments.

The Court also rejected the Aer Lingus appeal. It held that Ryanair's minority shareholding did not enable it to exercise decisive control over Aer Lingus. Like the Commission, it took the view that even though Ryanair shareholding was sufficient to block certain resolutions, this did not give it control. It concluded that there was not a concentration within the definition of the Merger Regulation because the merger had been prohibited by the Commission and the Commission did not therefore have the power to order Ryanair to dispose of its shareholding. This was despite the fact that the Commission had ruled that the acquisition of shares by Ryanair before and during the public bid constituted a "single concentration".

The Court also rejected a claim by Aer Lingus that the acquisition of a minority shareholding in a competitor undertaking in a duopoly inherently distorts competition because the company with such a shareholding has less incentive to compete with a company in whose profitability it is interested. The judgment only addressed this issue very briefly. It found that this claim was disproved by the fact that after acquiring its shareholding in Aer Lingus, Ryanair entered four routes previously served only by Aer Lingus and increased its frequencies on six other routes where it competes with Aer Lingus. The issue is whether Ryanair might have competed more aggressively if it did not have a shareholding in Aer Lingus.

3. Implications of Minority Shareholdings.

In March this year the OFT published a report which it had commissioned that considered the implications of firms' holding a minority interest in rival firms. The report defined a minority interest as an interest in a rival firm which stopped short of conferring control over the rival firm. It considered various ways in which such a minority interest could arise including minority shareholdings, inter-locking directorships, providing loans to rivals and Contracts for Difference (CfDs).

The report found that minority interests could be used to (further) soften competition and would thus lead to higher prices and lower output to the detriment of consumers. In the case of minority shareholdings, the report noted that the economic literature indicates that that a firm holding shares in a rival is likely to compete less aggressively with that rival because it will benefit from the success of its rival and suffer some loss if it takes business from it. If the shareholding firm competes aggressively with a rival in which it has a shareholding, any resulting financial losses suffered by the rival will have an adverse effect on the value of the shareholding firm's investment which reduces its incentive to compete. Even though the potential investment losses are likely to be smaller than the gains from winning business from its rival, having a minority shareholding reduces the incentive to compete compared to the situation in which it had no financial interest in its rival. This would essentially seem to be the argument advanced by Aer Lingus in its appeal to the EU General Court.

There is also a line of EU case law on joint dominance which is arguably relevant in this case. The *Airtours* [1] judgment established a three-part test for establishing joint dominance which has been restated in a number of subsequent EU court judgments:[2]

- The market must be sufficiently transparent for each member of the oligopoly to monitor the behaviour of other members;
- There must be a clear incentive for individual members of the oligopoly not to cheat by departing from any common policy on the market. Therefore, there should be adequate deterrents to ensure long-term compliance;
- It must be established that the reactions of any actual or future competitors, customers or consumers will not be able to jeopardise the results expected from the common policy.

The Commission's decision prohibiting the merger observed that both Aer Lingus and Ryanair monitored each other's fares and reacted regularly to changes in fares. It stated that both airlines used specific software to adjust their capacities and prices on a daily basis in response to competitive actions by the other.

4: Conclusions.

The OFT announcement that it intends to investigate Ryanair's minority shareholding in Aer Lingus under UK national competition law represents a further twist in a long running saga which looks set to continue for a little while yet. The OFT investigation will address two main questions:

1. whether it has jurisdiction under the Enterprise Act 2002 to review the acquisition as a relevant merger situation. This will include considering whether Ryanair has the ability to exercise material influence over the commercial policy of Aer Lingus as well as whether the OFT is within the statutory time period available to it to investigate the acquisition and, if need be, refer it to the Competition Commission; and
2. if so, whether the acquisition raises competition issues that would require it to refer the acquisition to the Competition Commission under the "substantial lessening of competition" test set out in the Enterprise Act 2002.

Fasten your seat belts there may be turbulence ahead.

[1] Case T-342/99 *Airtours plc v. Commission* [2002] ECR II-2585.

[2] See, for example, Case C-413/06 *Bertelsmann AG v Independent Music Publishers & Labels Association (Impala)* [2008] ECR I-4951.

Appeal Court Upholds Decision to Break-up UK Airports

1: Introduction.

On 13th October, the UK Court of Appeal upheld a decision by the Competition Commission (CC) ordering the British Airports Authority (BAA) to dispose of Gatwick, Stansted and one of either Glasgow or Edinburgh Airports. The CC had found in March 2009 that BAA's ownership of the three main London Airports – Heathrow, Gatwick and Stansted along with Southampton Airport had an adverse effect on competition. BAA's ownership of Aberdeen, Edinburgh and Glasgow Airports was also found to have had an adverse effect on competition. BAA appealed the CC decision to the Competition Appeals Tribunal (CAT) which overturned it on the grounds of apparent bias by a member of the CC panel that conducted the inquiry. The CC and Ryanair subsequently appealed and the Appeal Court overturned the CAT decision and upheld the original CC findings.

2: The Facts of the Case

BAA owned and operated seven UK airports namely Heathrow, Gatwick, Stansted and Southampton all in the South East of England, and three Scottish airports – Glasgow, Edinburgh and Aberdeen. As in the case of a number of other former state monopolies, BAA was successful in persuading the Government to privatise it as a single entity rather than break it up into a series of competing businesses. The decision not to separate the three London airports at the time of their privatisation was seen by some as denying passengers the benefits that might accrue from increased airport competition.

The CC investigation began in March 2007 following a referral by the OFT. The OFT reference required the CC to investigate whether there was an adverse effect on competition in the market or markets for airport services in the UK arising from the supply of airport services by BAA.

In August 2008, the CC published its provisional findings which found that BAA's ownership of the three London airports along with Southampton Airport and its ownership of the three Scottish airports reduced competition between airports. On 17th September 2008 BAA announced that it was to sell Gatwick Airport. The Commission published its final report on 19th March 2009 which concluded that BAA's ownership of airports in SE England and lowland Scotland had an adverse effect on competition.

BAA appealed the decision and on 25th February 2010, the CAT upheld the appeal and found that the decision was affected by apparent bias.

The CC has a full time chairperson and a number of part-time members. Each investigation is carried out by a panel of members. One of the six members of the panel, which carried out the airports inquiry, had acted as one of three external advisers to the Greater Manchester Pension Funds ("the Fund") since 1987. The Fund participants are the ten local councils in the Greater

Manchester area. The 10 councils also own Manchester Airport Group plc (MAG). MAG owns Manchester Airport and a number of other UK airports. MAG made submissions to the CC on the airport inquiry and subsequently attempted to purchase Gatwick Airport when it was put up for sale by BAA.

On 2nd December 2008, a representative of the Fund telephoned the panel member in question regarding its possible interest in participating with MAG in the acquisition of an airport. The panel member ended the call rapidly and was unaware that it involved Gatwick.

On 16th December 2008, the CC was informed that MAG and the Fund were interested in acquiring Gatwick Airport. The following day the CC published its provisional remedies proposals which proposed that BAA would be required to divest Gatwick and Stansted Airports and one of its Scottish airports. In the event Gatwick was sold to another party.

Following publication of the CC's final decision in March 2009, BAA appealed to the CAT alleging apparent bias. The CAT upheld the appeal finding that the CC proceedings were vitiated by apparent bias. The CC and Ryanair then appealed the CAT decision.

The CAT had ruled that the CC proceedings were vitiated by apparent bias from October 2007 when the CC became aware that MAG intended to play an active role in the inquiry and that it was in the market for further airport acquisitions. The Appeal Court noted that the panel member in question only became aware of a potential conflict of interest as a result of the telephone call from the Fund on 2nd December 2008. It held that prior to that date the individual concerned had no reason to believe that the Fund was going to participate in any possible MAG bid for Gatwick. The individual's relationship was with the Fund and not the MAG or the ten local authorities. Thus, the Court concluded that the relationship with MAG and its owners was *"too remote"* for apparent bias to be a real concern.

The relevant panel member was quarantined in relation to matters in respect of Gatwick with effect from 20th January 2009 and subsequently stood down in March 2009. Ryanair argued that the remaining five members of the panel were not contaminated by apparent bias and that the final decision which was taken by them should stand. The CC subsequently also made this argument. This issue was not addressed by the CAT since it had concluded that apparent bias had existed since October 2007. The Appeal Court, however, concluded that the issue of apparent bias only arose from 2nd December 2008. The Court noted that the panel's final conclusions were largely in line with those set out in its provisional findings and held that the final decision was not contaminated by any apparent bias.

3: Economic Analysis.

BAA's airports accounted for 60% of all UK airport passengers while the three London airports plus Southampton accounted for 91% of airport passengers in the South East of England. BAA's three Scottish airports accounted for 84% of Scottish airport passengers. The three London airports are defined as "designated airports" which means landing and other charges in those airports are regulated by the Civil Aviation Authority (CAA).

(a) The London Airports.

The CC report found that BAA's London airports faced very little competition from other airports. It found that there was significant substitutability of passenger demand between Heathrow, Gatwick and Stansted with significant overlaps in their catchment areas, although this varied to some extent between different categories of passenger. It also considered that there was some potential for competition between the three London airports and Southampton. It therefore concluded that BAA's ownership of all four airports adversely affected competition between them.

(b) The Scottish Airports.

In the case of airport services in Scotland, the CC found that there was an overlap in catchment areas between Edinburgh and Glasgow, particularly for leisure passengers. It cited consumer survey results which indicated that Edinburgh was the best alternative to Glasgow while Glasgow and the non-BAA owned Prestwick were the best alternatives to Edinburgh. It found that, apart from Prestwick, there was no effective competition to BAA airports in Scotland.

The CC expressed the view that there was potential for competition between Glasgow and Edinburgh airports and that BAA's ownership of both airports had an adverse effect on competition. The Report also suggested that there was scope for potential competition between BAA's Aberdeen airport and the other two airports, although it conceded that the evidence in that instance was less strong.

4: Comment.

The finding that the three London airports are substitutes from a passenger perspective is consistent with the EU Commission decision in *Ryanair/Aer Lingus*. Specifically, it supports the EU Commission view that airline routes should be defined on the basis of city pairs rather than airport pairs. The CC analysis, however, suggests that Glasgow, Prestwick and Edinburgh are in the same market, while the EU considered only Glasgow and Prestwick to be substitutes.[31]

BAA claimed that concentration of ownership concentrates planning expertise in a single airport operator and that there were economies of scale from joint ownership of airports in a particular area. The CC rejected these claims.

It is reported that BAA may appeal the Court judgement.

[3] The Competition Commission reported that Glasgow and Edinburgh Airports are 78km apart which it suggests is not much greater than the distance between Liverpool and Manchester (50km), Birmingham-East Midlands (58km) and Glasgow-Prestwick (59km). Interestingly the distance between Glasgow and Edinburgh airports (78km) is less than the 100km used by the EU Commission in the *Ryanair* case. The Competition Commission also notes that the distance from Glasgow city centre to Edinburgh airport is less than the distance between the two airports.

End of the Line for SSNIP Test?

1: Introduction.

On 19th August the US Department of Justice and Federal Trade Commission (FTC) unveiled new Horizontal Merger Guidelines. The new Guidelines represent the first substantial revision of the Guidelines since 1992.

The 1984 Guidelines are generally recognised as constituting the first real attempt to provide a coherent economic framework for merger analysis. The 1984 Guidelines and subsequent revisions have influenced competition agencies in other countries. The new Guidelines provide for some interesting shifts in approach. They remove the requirement to define the relevant market in all cases. They also provide for merger simulations and revisions to the HHI market concentration thresholds. The new Guidelines also include provisions regarding partial acquisitions which are of particular interest in light of the OFT decision to investigate Ryanair's minority shareholding in Aer Lingus (see above).

In contrast to the EU, the US authorities do not have power to prohibit anti-competitive mergers. Rather they must challenge such mergers in court. It is estimated that roughly 50% of merger challenges brought by US enforcement agencies between 1994 and 2009 were unsuccessful.[4]

2: Key Points.

(a) Market Definition.

Market definition has traditionally been regarded as the starting point in merger cases. The 1984 US Merger Guidelines led to increased attention on market definition and resulted in the development of the famous SSNIP test which is now widely accepted throughout the World. The new Guidelines, however, provide that market definition may not be the starting point in all merger cases.

> *"The Agencies' analysis need not start with market definition. Some of the analytical tools used by the Agencies to assess competitive effects do not rely on market definition, although evaluation of competitive alternatives available to customers is always necessary at some point in the analysis."* (p.7)

The Guidelines clarify this by stating that the analysis of unilateral effects cases need not start with market definition.

> *"Diagnosing unilateral price effects based on the value of diverted sales need not rely on market definition or the calculation of market shares and concentration."* (p.21)

In contrast the assessment of coordinated effects requires a definition of the market because such analysis is based on market concentration in conjunction with an assessment of

[4] O. Budzinski, An Institutional Analysis of the Enforcement Problem in Merger Control, *European Competition Journal* 6(2), August 2010.

whether the market is vulnerable to coordinated behaviour.

A number of economists have suggested that market definition is not always necessary for the analysis of mergers.[5] DG Comp's Chief Economist has expressed serious reservations about this aspect of the new Guidelines.[6]

If the analysis does not start by defining the relevant market, then there is no simple screening mechanism such as levels of market concentration which can be used to distinguish innocuous cases from potentially problematic ones. Despite this the Guidelines include market concentration thresholds for identifying which cases are likely to require detailed examination.

The statement that "evaluation of competitive alternatives available to customers is always necessary at some point" implies that the relevant market will have to be defined at some point. It is difficult to see how one could analyse the potential for brand repositioning and new entry if the relevant market has not been defined.

Both unilateral and coordinated effects can arise in any given case and the distinction between them may be blurred. [7] Given that the analysis of coordinated effects requires that the market be defined, it is difficult to understand any advantage arising from not defining the market at the outset.

(b) Market Concentration.

The new Guidelines have revised the market concentration thresholds. Table 1 compares the new thresholds in the 2010 guidelines with those in the 1992 version.

Table 1: Market Concentration Thresholds

Degree of Concentration	1992	2010
Low	<1,000	<1,500
Moderate	1,000-1,800	1,500-2,500
High	>1,800	>2,500

The thresholds are based on the Herfindahl Hirschman Index (HHI) which is the sum of the squares of the market shares of all the firms in a market. The thresholds have been increased significantly in the new Guidelines. For example, a market is considered highly concentrated when the HHI exceeds 2,500 whereas previously the threshold was 1,800.

The new Guidelines provide that in moderately and highly concentrated markets an increase in the HHI of 100 points as a result of a merger would potentially raise significant competition concerns and merit further scrutiny. An increase of more than 200 points in highly concentrated markets "will be presumed to be likely to enhance market power." (p.19)

(c) Types of Evidence.

[5] See, for example, J. Baker & C. Shapiro, Reinvigorating Horizontal Merger Enforcement that has Declined as a Result of Conservative Chicago Analysis, in R. Pitofsky, ed. *Where the Chicago School Overshot the Mark,* Oxford University Press, 2008 and G. J. Werden, Next Steps in the Evolution of Antitrust Law: What to Expect from the Roberts Court, *Journal of Competition Law & Economics*, 5(1), 2009.

[6] See, for example, D. Neven, *First Impressions on the Revised US and UK Merger Guidelines,* Address to Global Competition Review Conference, Brussels, 29th September 2010.

[7] This point is recognised in the Guidelines.

The Guidelines list various sources of evidence that is relied upon in merger cases. These include documentation obtained from the merging parties.

> *"Explicit or implicit evidence that the merging parties intend to raise prices, reduce output or capacity, reduce product quality or variety, withdraw products or delay their introduction, or curtail research and development efforts after the merger, or explicit or implicit evidence that the ability to engage in such conduct motivated the merger, can be highly informative in evaluating the likely effects of a merger."* (p.4)

In recent years the US courts have tended to place little reliance on such evidence. For example, internal documents indicating that the acquiring firm considered the merger anticompetitive were dismissed in *Whole Foods/Wild Oats* because they lacked explicit economic theory.

Simulation models are commonly used to analyse the likely effects of mergers and the guidelines state that the competition agencies may use such models. Simulation models suffer from a number of limitations which are widely recognised in the literature. In particular they are static models which do not take account of a whole variety of factors such as potential brand repositioning by rivals, new entry and countervailing buyer power. Such models are generally based on Nash Bertrand models of differentiated product markets which tend to predict price increases for all horizontal mergers no matter how fragmented the market in the absence of sufficient offsetting efficiencies. The Guidelines, however, state:

> *"The Agencies do not treat merger simulation evidence as conclusive in itself, and they place more weight on whether their merger simulations consistently predict substantial price increases than on the precise prediction of any single simulation."* (p.21).

(d) Efficiencies.

The new Guidelines contain some useful clarifications in respect of the analysis of efficiencies. They make clear that the assessment of whether efficiencies are merger specific is based on whether there are alternative means of reducing costs that are practical in light of the circumstances in which the firms operate. Theoretical alternatives are not considered.

> *"Only alternatives that are practical in the business situation faced by the merging firms are considered in making this determination. The Agencies do not insist upon a less restrictive alternative that is merely theoretical."* (p.30)

(e) Partial Acquisitions.

The new Guidelines also address the issue of partial acquisitions. They note that such acquisitions may present significant competitive concerns even if they do not result in the acquirer having effective control over the other undertaking. There are three principal issues that arise in such cases.

1. The ability of the acquiring firm to influence the competitive conduct of the target.
2. A partial acquisition may lessen the incentive for the acquiring firm to compete.

3. A partial acquisition may give the acquiring firm access to competitively sensitive information about the target.

3: Conclusions.

The new US Merger Guidelines involve some significant changes in merger analysis. In particular the suggestion that merger analysis need not start with a definition of the market represents a significant shift. Some economists have questioned whether this represents a useful approach.

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