Compecon Limited

Analysing Mergers.

Submission to the Competition Authority.

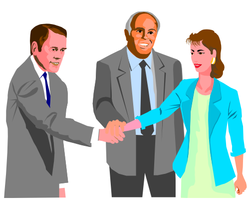
24th September 2002.

1: Introduction.

This submission was prepared in response to the various consultation documents published by the Competition Authority relating to the new merger control regime to be introduced with effect from 1st January 2003 on foot of part III of the Competition Act, 2002. The Authority published three documents namely:

- Guidelines for Merger Analysis;
- Draft Procedures of the Competition Authority in the Review of Mergers and Acquisitions; and
- Draft Form for Merger Notification.

This submission is primarily concerned with the first of these documents, although some comments are included in respect of the other two. In addition, the submission also addresses some comments made by representatives of the Authority regarding the analysis of mergers at its conference on 9th September.

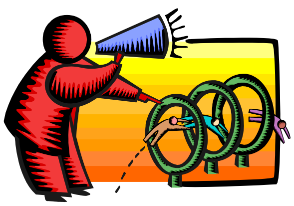


In general, the publication by the Authority of the various draft guidelines along with an invitation to comment is a positive step. Many of the proposals contained in the documents are reasonable and are consistent with good practice in the area. The comments contained in this submission are confined to suggesting improvements in certain areas.

2: Guidelines for Merger Analysis.

(i) The SSNIP test.

In describing how the Authority would apply the SSNIP test, para 2.5 states that it 'uses prevailing prices of both the products of the merging firms and possible substitutes for such products, unless pre-merger circumstances indicate that such prices represent a substantial departure from competitive levels.'

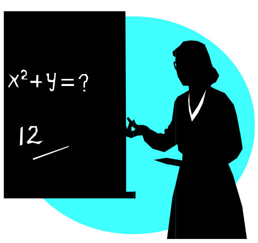


Using the SSNIP test to define the market in possible abuse of dominance cases is complicated by the fact that the dominant firm is likely to have already raised its prices as much as possible, i.e., to just below the point where enough consumers would switch to make further increases unprofitable. Applying the SSNIP test on the basis of prevailing market prices would therefore result in an incorrect definition of the market. This, in essence, is the so-called *cellophane trap.* However, such considerations are not relevant for defining a market when analysing the competitive impact of a merger. This is because, in assessing the competitive impact of the merger the crucial issue is not whether one of the merging parties already enjoys a degree of market power, but whether, as a result of the merger, the degree of market power would increase. Thus, in defining the market for the purposes of merger analysis the SSNIP test should be applied on the basis of prevailing market prices.

Prevailing market prices should not be used where there is evidence of collusion in the market. Where firms have sought to collude, then collectively they will seek to behave like the dominant firm and raise price to the maximum extent possible. In this instance the objective of merger control is to prevent mergers which would facilitate collusion. Defining the market on the basis of prevailing prices could lead to an incorrect conclusion that the merger would not facilitate collusion because the firms could not raise prices any further, when in fact the objective of the merger may be to make collusion more effective. In other words, unless prices are believed to be significantly above competitive levels as a result of collusion, prevailing market prices should be used in applying the SSNIP test.

(ii) The HHI.

There is considerable merit in using the HHI to identify mergers which are unlikely to prove problematical, provided it is clear that that is purpose of such a measure. An indication that mergers below certain thresholds are unlikely to pose any threat to competition is likely to increase predictability and reduce the burden on the notifying parties. For example, they are unlikely to have to devote time and resources to compiling evidence on entry barriers, efficiency gains and other factors. Provided they have defined the market correctly and the post merger HHI is below the level at which a merger might raise competition concerns, then the notifying parties and their advisors need not incur the unnecessary expense of further analysis and argumentation. The Draft, however, states, at para 3.11, that the zones do not constitute a 'safe harbour' and that even mergers in the green zone might be subject to further analysis in certain circumstances. A HHI less than 1,000 is equivalent to a market with ten equally sized firms. It is not clear what competition problems are likely to arise in such circumstances.



It needs to be clear, however, that where the HHI is above certain levels that it represents nothing more than an indication that some further examination is required but that this does not necessarily indicate that a Phase II investigation is required, much less that a prohibition of the merger is likely. The drafting of the document is somewhat ambiguous in this respect. For example, the reference to Green, Orange, and Red zones may convey an impression that those mergers falling into the latter category are, almost by definition, at serious risk of being blocked. This is compounded by the wording in para 3.10, for example, which states that:

> 'Mergers falling in the orange zone will be presumed capable of raising significant competitive concerns and are likely to require further analysis. Red zone mergers occur in already highly concentrated market and are the most likely to lead to a SLC, thus such mergers will almost always require further analysis.'

The Draft asks whether the HHI threshold levels should be changed. It is not clear that the orange zone serves any useful purpose. A HHI of between 1,000 and 1,800 implies a market with between 5.6 and 10 theoretically equally sized firms. It is not clear that serious competition problems are likely to arise at those levels of market concentration. In addition, given the size of the Irish economy a large number of mergers are likely to occur in markets with post merger HHIs greater than 1,000, implying that a sizeable number of harmless mergers would be subject to further examination. While the thresholds are in line with the Authority's past practice, it does not appear that the Authority has in the past identified competitive concerns in the case of mergers falling within this range. Consequently, there would seem to be a case for either dropping the orange zone altogether or for significantly raising the lower threshold at which it is applied, say to around 1,500, i.e., equivalent to a market with 6.7 equally sized firms.

In contrast there would not appear to be a sound economic basis for raising the 1,800 threshold. The latter threshold, which is equivalent to a market with 5.6 equally sized firms, appears to reflect indications that there is a real risk of coordinated effects or collusion in markets with less than six firms. There does not appear to be any evidence that the risk of collusion depends on the size of the economy, independent of the number of firms. The 1,800 threshold appears to be about right.

The lower threshold of the orange zone appears too low. One option would be to increase it to, say, 1,500. There does not appear to be a sound basis for raising the red zone threshold from 1,800. This would leave a relatively narrow orange zone. It would appear preferable to abolish the orange zone altogether and provide that where the post merger HHI was less than 1,800 further examination would not be required unless the combined market share of the merging firms exceeded 35%. Admittedly in many instances where the merging parties combined market share is 35% or more, the HHI will fall in the red zone but it sometimes will not. A combination of a HHI below 1,800 and a single firm with a market share of 35% or more would suggest a sufficient risk of unilateral behaviour by a firm with a potentially dominant market position to justify further investigation.

(iii) The Failing Firm Defence.

The Draft proposes having no failing firm defence. Such a defence is established in US and EU case law. In addition, the refusal to grant an injunction to the Authority in the *Glanbia/Athboy* case appears to have been in part implicitly due to such considerations.

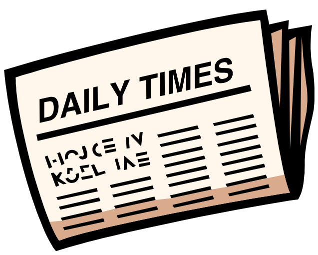
More importantly a rejection of the failing firm defence implies that a merger would be blocked even though the target firm would be forced to exit the market. The economic rationale for the failing firm defence rests on the proposition that, without such a defence, the output of the failing firm would be lost to the market, thus lowering consumer welfare. Although a failing firm merger might be anti-competitive and thus involve some reduction in consumer welfare, it could result in a lesser decline in output and welfare than the outright closure of the failing firm. Consequently, on consumer welfare grounds, which the Authority has identified as the criteria for deciding if there is a substantial lessening of competition, the failing firm defence may be justified in certain circumstances.

The arguments put forward by the Authority on page 33 for rejecting the failing firm defence are not convincing. For example, as the failing firm defence would only allow an anti-competitive merger in the absence of any other buyer willing to pay above the liquidation value, it is not clear that it would reward failure. It is suggested that it would open the door to other defences that would not be appropriate without specifying what these might be. It also claims that in past cases 'where a failing firm issue has been raised, the Authority has not found the defence to be particularly useful or clear in its application'. The record of past Authority decisions suggests otherwise, at least in the majority of such cases.

3: Draft Procedures of the Competition Authority in the Review of Mergers and Acquisitions.

(i) Publication.

The draft states at para 2.9 that, following a determination that a merger may be put into effect, the Authority will inform the notifying parties and any other undertaking or third parties who have made submissions that it has so determined. It further states that it will publish the determination upon its website within two months thereafter. It is recognised that there might be some delay involved before the Authority could publish a full decision. It would appear desirable that the Authority should announce that it has taken a decision as soon as the parties have been informed.



If both the parties and any third parties, who have made submissions, have been notified, there is a strong prospect that, in some cases at least, news of the determination would come into the public domain before the Authority formally publishes its decision which is somewhat unsatisfactory. It may also give rise to misguided perceptions of inconsistency, i.e., why do some decisions become public before others, and create an impression that some firms have an inside track, i.e., firm A was able to announce that it had got the all clear two months before the announcement. In addition, if decisions become public before the publication of the Authority's decision it will give rise to possible inaccurate speculation as to the reasons for the decision. Such developments could damage public perceptions and confidence regarding the independence and impartiality of the process.

In the case of publicly quoted companies there is a further problem. Information that the merger has been cleared is obviously market sensitive and there may be problems in releasing this information to some parties while not making it generally available. It may be necessary to ensure that the Authority's procedures regarding publication of decisions are consistent with stock exchange rules.

The same considerations apply with regard to the publication of a determination to conduct a second stage in-depth investigation and with regard to final decisions at the end of the Phase II investigation. In the former case there is a further issue as the Authority has indicated that in some instances it will have reached a conclusion that a merger may proceed within six weeks of commencing a Phase II investigation, i.e., two weeks before the decision to undertake such an investigation would be published. It seems somewhat illogical for the Authority to announce that it has decided to undertake a Phase II, two weeks after it may have decided that the transaction was okay, but to delay announcing the latter decisions for a further six weeks. Presumably if firms in those circumstances are asked to comment they will indicate that in fact the transaction was cleared two weeks previously which appear to make a nonsense of the process.

While some delay might be required before the Authority would be in a position to publish the full text of its decision, it would appear that it should announce decisions at each stage of the process, by means of a press release as soon as the parties have been informed.

(ii) Other Procedural Issues.

A number of other important issues relating to procedure are not specifically addressed in the Consultation Document. In Mr. Purcell's address to the conference on 9th September, he stated that: 'where the Authority decides, after an initial Phase I examination, that a merger may go ahead, I think it's likely that we will publish merely summary details of the case. These details would include the identity of the parties, the general nature of the transaction, and a statement that, in the Authority's opinion, the merger would not lead to a substantial lessening of competition.'

Apart from the statement of the Authority's opinion that the merger would not lead to a substantial lessening of competition, all of this information would appear to be included in the notice that the Authority would have published within seven days of the notification being made. More importantly the publication of such limited information regarding the Authority's determination does not sit comfortably with the notion of increased transparency which is presented as the hallmark of the new regime.

It is important for businesses and their advisors that the Authority publishes the reasoning behind such decisions. Such information provides obvious guidelines for business as to which sort of mergers are likely to be approved and which ones might prove problematical. The latter information is particularly important since it might save firms considerable time and expense in bringing forward transaction that are unlikely to be approved.

A second reason for publishing such information is that it would provide a necessary 'quality check' of the Authority's decision making in ensuring that its analysis was in line with best practice. There is no right of appeal by third parties against decisions to clear mergers. Publication of the Authority's analysis would allow some external review of the quality of decisions and, while this could not lead to a reversal in a case that had been decided, if mistakes were identified as a result of such publication, at least there might be some prospect that they would not be repeated.

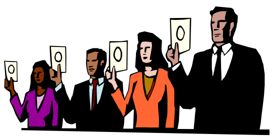
By definition, the Authority will have undertaken an analysis of the merger and have identified reasons for clearing it, so there is no obvious reason for not publishing such information.

Mr. Purcell also appeared to say, although it is not stated in his script, that one option being considered by the Authority was to delegate decision making at the initial investigation stage to one member, i.e., the decision whether to approve or conduct an in-depth investigation. This seems undesirable. As noted, there is no right to appeal such approval decisions. This means there are no checks in the legislation to prevent 'Type II' errors, i.e., failures to identify and prevent anti-competitive mergers. At the conference, the Authority Chairman expressed some concerns about the danger of such errors. In the absence of any external review mechanism to prevent such errors, it would seem incumbent on the Authority to put some form of internal checks in place. This would suggest that, at the very least, decisions at the Phase I stage should be made by a quorum of three members rather than one. The combination of delegating responsibility for Phase I decisions to one Authority with the previous proposal not to publish any reasons for such decisions would certainly increase the likelihood of 'Type II' errors.

There is a further issue with respect to the question of who makes the decisions, and this applies at both the Phase I and Phase II stages. Concerns have been expressed at the idea that the individuals who conduct the investigation also make the decisions. The Authority's representatives have argued that the process is not an adversarial procedure and that, therefore, the analogy is misplaced. They have argued that the Authority's function prior to the decision is one of gathering factual information in a purely disinterested way. The position of the parties would appear to be rather different. They clearly have an interest in only one type of outcome, i.e., approval of the transaction. They cannot be expected to embark on the same disinterested search for objective truth in which the Authority claims to be engaged. More importantly at a stage where the Authority has decided to undertake a Phase II investigation and has issued a statement of objections, it is difficult for the parties to accept that those on the other side of the table are completely open to new arguments.

It is a necessary human foible that individuals who have prepared and approved a statement of objections, for example, might be reluctant to change tack. It has been observed that other agencies which operate in a similar fashion have, on occasion, demonstrated a tendency to reach conclusions on the basis of lower standards of proof than might be required by an independent adjudicator such as a court. The Authority has itself expressed the view that some separation of roles is required in the case of EU merger decisions.

Other commentators have suggested that the difference in approach by the EU Commission and the US FTC in the *Boeing/McDonnell Douglas* merger was due in part to the fact that the former had the power to block the merger itself, whereas the latter would have had to prove to a court that blocking the merger was justified. It has been claimed that the Commission's initial objections were based on evidence which would have been thrown out by a US court.[1] Similarly it has been observed that US FCC, which may block mergers without going to court, has blocked mergers which had been cleared by the antitrust authorities who are burdened with the necessity of making their case before a court.[2]


Like it or not perceptions are important. The Authority could go a long way to addressing such issues. While one member might be given responsibility for heading up the investigation and bringing forward a recommendation, that member would not be involved in making the decision. Instead, decisions at both the Phase I and Phase II stages could be taken by a panel comprised of three of the other four members of the Authority. This would not appear to put an undue burden on Authority members, as merger decisions are one of the Authority's major functions under the new Act.

[1] W.E. Kovacic, (2001); Transatlantic Turbulence: The Boeing-McDonnell Douglas Merger and International Competition Policy, *Antitrust Law Journal*, 68(3): 805-73.
[2] W.J. Kolasky, (2001): The FCC's View of the Bell Atlantic/NYNEX and SBC/Ameritech Mergers: Regulatory Overreach in the Name of Promoting Competition, *Antitrust Law Journal,* 68(3): 771-803.

4: Draft Form for Merger Notification.

The form at para 2.4 requests the parties to:

> ‘Provide all reports, studies, surveys and analyses that were prepared for or received by a senior officer, together with an indication of the date of preparation, and the name and title of the author of each document, for the purpose of evaluating or analyzing the proposed transaction with respect to the principal categories of goods or services affected, its potential impact on prices, the market shares, the competition or the competitors for these categories, innovation and the potential for sales growth, or expansion into new products or geographical regions.’

It would appear that this requirement is designed to obtain detailed background information about the merging parties’ views and objectives with respect to the merger. Presumably, the existence of such a requirement is likely to encourage firms to be extremely circumspect in what they include in any such documents, thus, to some extent at least, defeating the purpose. Anecdotal evidence suggests that the Freedom of Information Act, has resulted in less information being recorded within the public sector. Private sector firms and their advisers are likely to show a similar degree of ingenuity in the face of such a requirement.

On the other hand, documents such as strategic business plans, marketing plans, and plans for new product launches prepared by the companies prior to the initiation of any merger discussions might be far more useful. Such documents are likely to provide useful insights into the companies’ views regarding the relevant market; who its competitors are; product positioning; likely competitive responses, which is the sort of information required for analysing the competitive effects of any merger. The parties’ views before they contemplated any merger might be more useful than any documents prepared in the context of the merger.

5. Summary and Conclusions.

(i) Merger Analysis Guidelines.

- The SSNIP test should use prevailing prices unless there is evidence of collusion.
- The HHI should be used to identify 'safe harbour' thresholds below which mergers are unlikely to pose competition problems as this would reduce the burden of notification and improve predicatability.
- The orange zone should be dropped and the 1,800 threshold should be retained. Mergers where the post merger HHI is below 1,800 would be presumed not to pose any threat to competition unless the merging firm had a market share of 35% or more.
- It should be clear that the application of such thresholds represents only an initial or preliminary stage in the investigation process designed to eliminate harmless mergers and that exceeding these thresholds would not necessarily lead to a Phase II investigation, much less a blocking of the merger. References to 'red zone' and to the effect that mergers above these thresholds 'will almost always require further analysis' should be amended consistent with this.
- There should be a 'failing firm' defence as such a defence is consistent with consumer welfare.

(ii) Procedural Issues.

- Once the parties have been notified of a determination to approve a merger; conduct a Phase II investigation; or the result of a final determination following a Phase II inquiry, the Authority should issue a press release announcing the decision.
- In cases where the Authority has decided at the end of Phase I that the merger may proceed, it should publish the reasons for such decisions.
- Decisions at the Phase I stage should be made by a minimum of three Authority members as a check against Type II errors.
- Having an individual who is responsible for investigations participate in decision making is inevitably likely to create perceptions of unfairness. This could be

avoided if the member responsible for merger investigations was not one of the three members taking decisions at both the Phase I and Phase II stages.

(iii) Notification Form.

Reports prepared in the context of the merger may be of limited use while business plans and other strategic documents prepared by the individual firms before the merger was mooted might be far more useful.