Compecon – Competition Economics

Submission on Competition Authority Guidelines for Merger Analysis.

31st January 2011

1: Introduction.

This submission is made by Compecon in response to the Competition Authority Consultation on its Guidelines for Merger Analysis dated 3rd December 2010. The Authority's existing Merger Guidelines were published in December 2002. Compecon welcomes the decision by the Authority to undertake a review of the Guidelines. It is our understanding that this consultation represents the first stage in reviewing the Guidelines and that following this consultation process, the Authority will publish new draft Guidelines and seek the views of interested parties on those draft Guidelines. Indeed, in many cases the Consultation paper simply provides a broad outline of topics that might be addressed with no detail of any proposed revisions. While in general accepting the need for the Guidelines to be updated at this stage, one would need to see the details of what is being proposed before coming to any conclusions.

The consultation paper states that the Guidelines could be revised and updated to take account *inter alia* of the Authority's experience of making over 400 decisions under the Competition Act, 2002. It is important to recognise that the vast majority of mergers notified under the Act involved no competition nexus with Ireland. This reflects the provisions of the legislation something which is outside the scope of a review of the Authority's Guidelines. Gorecki et. al. reported that, of more than 300 mergers notified to the Authority over a 4-year period up to mid-2007, only 17 required a detailed economic analysis. The low figure was attributed, in part, to the legislation being overly broad in scope.[1] Compecon's analysis indicates that of 447 mergers notified between July 2003 and December 2009, only 19 were subject to a Phase 2 review. A further five cases were cleared at Phase 1 on foot of undertakings given by the parties suggesting that a total of 24 cases out of 447 mergers notified to the Authority raised competition concerns. Many of the mergers considered by the Authority did not require any detailed economic analysis and are therefore of little use from the point of view of reviewing the Authority's

[1] P. Gorecki, C. Keating & Brendan O'Connor, The Role of Economic Evidence in Merger Control in the State: Current and Future Practice, 3EUR. COMPETITION J. 345 (2007). The Authority has indicated that it would like to see changes in the legislation that would greatly reduce, if not eliminate, such notifications.

Guidelines. The small number of cases which required a more detailed analysis may, however, provide useful lessons for the future.[2]

Compecon's analysis of the potential problem cases suggests that there are a number of issues which need to be addressed in any review of the Authority's Merger Guidelines. The Authority's decisions display an over reliance on qualitative analysis. In our view greater emphasis should be placed on quantitative analysis. In addition, in some cases the Authority's analysis is not entirely consistent with the relevant economic literature and international best practice. These issues need to be addressed in any review of the Guidelines.

The Consultation Paper focuses on 12 aspects of the existing Guidelines, namely:

1. Measurement of Market Definition;
2. Effect of a Merger on Market Structure;
3. Substantial Lessening of Competition;
4. Theories of Harm;
5. Failing Firms;
6. Competitive Constraints;
7. The Counterfactual;
8. Entry;
9. Countervailing Buyer Power;
10. Efficiencies;
11. Maverick Firms; and
12. Remedies.

Each of these issues is addressed in turn in the present submission.

[2] For ease of reference throughout the remainder of this submission the 24 cases that raised significant competition concerns are referred to as the potential problem cases.

2: Market Definition.

2.1: Introduction.

The Consultation document states:

> *"2.3 The 2002 Merger Guidelines' presentation of market definition could be read as implying that market definition is both a necessary and sufficient step in merger analysis. However, our experience has shown that this is not how merger transactions are reviewed in practice. Rather than being an end in itself, market definition is an analytical tool that can assist the review of proposed transactions.*
>
> *2.4 For the vast majority of mergers notified to the Competition Authority, the Competition Authority has taken the view that it is not necessary to reach a final conclusion on the definition of the relevant markets."*

The Consultation states that the 2010 UK guidelines provide that market definition, although a useful tool is not an end in itself. Similarly, the ACCC has stated that while market definition is a useful tool for merger analysis, it cannot by itself determine a merger's impact on competition. This is something that has long been recognised in the relevant economic literature which states that market definition in merger cases is simply an analytical tool. Werden, for example, described markets as *"the tools used to aid in the assessment of market-power related issues."*[3]

The existing Guidelines clearly provide that market definition is neither necessary nor sufficient to establish the competitive impact of a merger.

> *"It is not always necessary to reach a firm conclusion on market definition if more direct measures of market power are available. This may hold, for example, where it is clear that the merger does not raise competition concerns on any reasonable definition of the market. Alternatively, a market may not be defined if the transaction clearly gives rise to adverse competitive effects."* (Para 2.2).

[3] G.J. Werden, (1992), Four Suggestions on Market Delineation, *Antitrust Bulletin*, 37(1):107-21 at 108.

The Authority in a number of decisions has concluded that it was not necessary to come to a definitive conclusion on market definition in order to decide that a merger would result in a substantial lessening of competition. This was because either:

a. an SLC was unlikely in the case of any reasonable definition of the market; or
b. an SLC was unlikely even on the basis of the narrowest possible market definition.

It should be noted, however, that in such cases the analysis of competitive effects still takes place within the framework of a particular "market" or "markets". In the case of option (b) there is an implicit assumption that if an SLC will not arise even in the narrowest possible market then it cannot arise in a more broadly defined market. In general, this will be the case. If, however, the narrowest possible market indicates that no SLC will arise because the merging parties are in separate markets, then the issue of market definition should be analysed in more detail.

The EU Commission has stated in numerous merger cases that it was not necessary to define the relevant market precisely in order to reach a conclusion on the likely competitive impact of a merger. The Consultation states that the 2010 UK guidelines note that it is not **always necessary** to **precisely** define the boundaries of the relevant market while the ACCC has also recognised that it is **often possible** to determine a merger's likely impact on competition without **precisely** defining the boundaries of the relevant market. Again, there is nothing new in such arguments. Importantly both state that it is not necessary to define the market precisely in every case. Recognising that a precise market definition is not necessary in every case does not mean that there is no need to define a relevant market at all.

The Consultation points out that the revised US Merger Guidelines state that market definition is no longer a prerequisite to undertaking competitive effects analysis but is complementary to a direct analysis of competitive effects. The US Guidelines state:

> *"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."* (Page 7, emphasis added)

Thus, the US Guidelines state that market definition need not be the starting point of any merger analysis but recognise that it will always be necessary to evaluate the competitive alternatives available to customers. It is difficult to see how such an evaluation could be conducted without defining the relevant market.[4] The US Guidelines stop short of stating that market definition can be dispensed with in merger analysis although some economists have advocated such an approach.[5] The latter view has, however, proved somewhat controversial with DG Comp's Chief Economist expressing serious reservations.[6]

It is also important to recognise that the US Guidelines provide that in analysing potential unilateral effects the agencies may construct economic models where sufficient data is available. *"These merger simulation methods need not rely on market definition."* (Page 9) There is no indication in the Authority Consultation paper that it proposes to adopt such analytical tools. Gorecki et. al. suggested that investing resources in simulation models, given their obvious flaws, may add little value for a small agency, which had made only two prohibition decisions in 4 years. The literature recognises that simulation models suffer from a number of limitations. 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. Simulations which are based on Nash Bertrand models of differentiated product markets inevitably predict price increases for all horizontal merges no matter how fragmented the market, in the absence of sufficient offsetting efficiencies. Merger analysis therefore requires an analysis of dynamic factors such as the potential for brand repositioning and potential entry. For that reason, merger simulations do not dispense with the need to define the relevant market at some stage in the analytical process.

The Authority Consultation paper suggests that the Merger Guidelines could be amended and updated to clarify that:

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[4] J.J. Simons & M.B. Coate, Upward Pressure on Price Analysis: Issues and Implications for Merger Policy, *European Competition Journal*, 6(2), August 2010.

[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.

- Market definition and the SSNIP test, while useful analytical tools for merger review, cannot by themselves identify the competitive impact of a merger;
- Market definition is not always necessarily a pre-requisite to the conduct of a competitive effects analysis; and,
- Market definition is more likely to be necessary when reviewing mergers with significant overlap(s) (horizontal or vertical, or both) in the activities of the parties. (Para 2.6).

The proposal that the Guidelines should be amended to provide that market definition of itself cannot identify the competitive impact of a merger is consistent with the economic literature and international best practice. However, this is not very different from the Authority's existing guidelines and practice.

The statement that market definition is not always necessarily a pre-requisite to the conduct of a competitive effects analysis is more problematic. There is disagreement on this in the literature. As pointed out, the UK and Australian guidelines state that it is not always necessary to define the relevant market precisely while the US Guidelines state that merger analysis need not necessarily start with market definition but recognise that evaluation of competitive alternatives available to customers, which by definition requires some definition of the market, is always necessary**.** None of these approaches seems to go so far as to suggest that it is not necessary to define the relevant market. Thus, the Authority proposal seems inconsistent with international best practice. There appears to be no good reason for altering the existing position which recognises that it is not always necessary to define the market precisely in order to reach a conclusion on the likely competitive impact of a merger.

Identifying the relevant market provides a framework for analysing competitive effects, e.g., it identifies which products exercise a competitive constraint on the merging brands, whether there is potential for entry and other factors that are relevant to the analysis of competitive effects. For example, in *Alphyra/Eason Electronics* the Authority reviewed a merger between parties that supplied terminals and other equipment that are used in the sale of phone credit top-ups to retail outlets. The determination found that the transaction would not result in any diminution of competition because there were various alternative ways for customers to purchase credit top-ups. It is not clear why the Determination focused on this as arguably the issue was whether the transaction would enable the merged firm to raise the cost of the equipment to retailers and not the price charged to consumers. This serves to illustrate the need to couch the competition analysis in the context of the relevant market. Defining the relevant market also provides a simple screening mechanism such as levels of market concentration which can be used to distinguish innocuous cases from potentially problematic ones.

The Authority's third proposal recognises that market definition is likely to be necessary when reviewing mergers where there is a significant overlap in the merging parties' activities. This suggests therefore that, apart from those cases which involve no competition nexus with Ireland, market definition should continue to be regarded as an important step in merger analysis.

The Consultation Paper notes that the ACCC and OFT have cited difficulties involved in applying the SSNIP test in practice but offers no proposals on this issue. The SSNIP test is generally recognised as the most appropriate test for market definition. Analytical tools such as the critical elasticity of demand or the critical loss provide a useful mechanism for applying the SSNIP.[7] It can often be difficult to obtain the information required to formally apply the SSNIP test in Irish merger cases. Nevertheless, such analytical tools can still provide useful information which can assist in defining the relevant market.

The critical loss is the maximum volume of sales that can be lost as a result of a price increase such that profits after the price increase remain unchanged. If the loss of sales in response to a price increase exceeds the critical loss, then the price increase is unprofitable and thus the products involved do not constitute a relevant market. The critical loss can be estimated using a relatively simple formula

$$y = t/(m+t)$$

where y is the critical loss, t is the chosen level of price increase, typically 5% in the case of the SSNIP test and m is the price-marginal cost margin. Table 3.1 illustrates critical loss values for price increases of 5% and 10% for a range of different price-cost margins.

[7] See P. Massey & D. Daly, (2003), *Competition and Regulation in Ireland The Law and Economics*, Oak Tree Press, chapter 5.

Table 3.1: Critical Loss Values		
% Price-Cost Margin	% Price Change	
	5%	10%
10	33.3	50.0
15	25.0	40.0
20	20.0	33.3
25	16.7	28.6
30	14.3	25.0
35	12.5	22.2
40	11.1	20.0
45	10.0	18.2
50	9.1	16.7

The table illustrates that the critical loss declines as the price-cost margin increases. Thus, when price-cost margins are relatively low, a very large decline in sales is required to render a price increase unprofitable. In the case of a price-marginal cost margin of 30% a drop in sales of more than 14.3% would render a 5% price increase unprofitable. A drop of just over 20% would be required to render a 10% price rise unprofitable. Price-marginal cost margins could easily be around 30% or more in many industries. The key message is that in applying the SSNIP test it is important to recognise that in many industries, it may not require a very large decline in sales to render a price increase unprofitable. It is sometimes implicitly assumed that a large proportion of customers must switch but this is incorrect. It is important when applying the SSNIP test to recognise that it is marginal customers not the average or mean customer that matters. This point could usefully be incorporated into the Authority's Guidelines.

Surveys can provide useful guidance on market definition. The Authority has frequently included questions designed to provide information that would assist in defining the relevant market in questionnaires sent to customers in various cases. In some cases, however, the Authority has found that it was not possible to come to any conclusion on market definition on the basis of the responses obtained, e.g. *Kerry/Breeo* and *Metro/Herald AM*. This appears in part to be due to a failure to frame questions in a way that would elicit useful responses.[8] Better use of surveys and particularly using more focused questions that explicitly seek to quantify the likely impact of a price increase on sales, combined with critical loss analysis could provide a useful mechanism for the application of the SSNIP test for defining markets.

Compecon's views may be summarised as follows:

- Market definition and the SSNIP test, while useful analytical tools for merger review cannot by themselves identify the competitive impact of a merger.
- It is not always necessary to define the relevant market **precisely** in order to analyse the competitive effects of a merger but, in our view, it is not correct to state that market definition is not always necessarily a pre-requisite to the conduct of a competitive effects analysis.
- Market definition is more likely to be necessary when reviewing mergers with significant overlap(s) (horizontal or vertical, or both) in the activities of the parties.
- Critical loss analysis can be a useful tool for applying the SSNIP test and can provide a useful conceptual framework for the application of the test.
- In applying the SSNIP test it must be remembered that it is the response of marginal rather than average customers that matters.
- Properly designed customer surveys can be a useful tool for defining relevant markets.

[8] In contrast surveys provided useful evidence for defining the relevant market in cases such as *Heineken/Scottish & Newcastle* and *Galco/Sperrin.*

3: Effect of a Merger on Market Structure.

It has long been recognised in the economics literature that high levels of market concentration do not necessarily mean that a merger will adversely affect competition. By the same token it is also recognised in the literature that mergers will not give rise to competition concerns in markets where post-merger concentration levels are relatively low. The most frequently used measure of market concentration is the Herfindahl-Hirschman Index (HHI) which is the sum of the squares of the market shares of all firms in the market. The Competition Authority, in line with competition agencies in many other jurisdictions, has set out certain HHI "safe harbour" thresholds, which indicate the point above which a merger might raise competitive concerns. The current thresholds were based on the levels set in the 1982 US merger Guidelines which have recently been revised upwards. The Consultation asks for views as to whether the HHI thresholds and deltas should be changed from the current level and, if so, what should be the revised levels?

The HHI thresholds applied by the Authority are set out in Table 3.1.

Table 3.1: Competition Authority Merger Zones		
Definition		
Zone	HHI	Change
A	Less than 1000 Between 1000 and 1800 Above 1800	Any Less than 100 Less than 50
B	Between 1000 and 1800 Above 1800	Greater than 100 Between 50 and 100
C	Above 1800	Greater than 100

These thresholds divide mergers into three different categories or zones. Mergers in Zone A are considered less likely to have adverse competitive effects. Mergers falling in Zone B may raise competition concerns. Zone C mergers occur in already highly concentrated markets and are more usually those that raise competition concerns. While the Guidelines do not provide for a "safe harbour", transactions falling within Zone A are relatively unlikely to result in a detailed investigation. While understandably the Authority does not wish to restrict its discretion arguably the greatest benefit of a concentration measure such as the HHI is in providing a useful tool to identify mergers that are highly unlikely to raise competition concerns. This can assist the Authority in taking decisions as to which mergers require detailed scrutiny and which do not. It can also assist notifying parties by reducing the requirement for expert analysis in support of arguments that a merger would not result in an SLC.

In asking whether the thresholds should be increased the Authority points out that the latest US Guidelines have increased the upper threshold from 1800 to 2500 and the delta from 100 to 200. The Consultation paper makes no reference to Australia and the UK which have lower thresholds although it cites all three countries on most issues. The ACCC has an upper threshold of 2000. The OFT Guidelines in contrast state that a post-merger HHI exceeding 1,000 may be regarded as concentrated and a market with a post-merger exceeding 2,000 as highly concentrated. (Para 5.3.5).

HHI measures of market concentration provide some useful information, and this should be considered when asking if the Guidelines should be revised. The maximum value of the HHI is 10,000 which corresponds to a monopoly. Dividing the maximum possible HHI value by its actual value tells one the number of theoretically equal sized firms that corresponds to any particular value of the HHI, i.e., a market with a HHI of 2,000 corresponds to a market with five theoretically equal sized firms. Similarly comparing the actual number of firms with the number of theoretically equal sized firms as indicated by the HHI again provides useful information on market structure.

The literature recognises that coordinated effects are only likely to arise in markets with a relatively small number of firms. There is a volume of literature which argues that tacit collusion is difficult to sustain if there are more than four firms in a market because the addition of a fifth firm means that it will be in one firm’s interest to cheat.

Similarly, the literature recognises that a high level of market concentration is necessary for unilateral effects although it is less prescriptive on the level of concentration required. If a market has a low level of concentration, by definition there will be a large number of firms. This implies that there are likely to be a number of close substitutes for any particular brand which tends to significantly reduce the risk that a merger would remove a competitive constraint on the merging brands.

Looking at the existing thresholds, it seems clear that a market with a post-merger HHI of 1,000 or less is unlikely to raise any competition concerns. Effectively this implies a market with at least ten firms, and it is very difficult to see any theory of competitive harm that would be applicable to such a scenario. Similarly, a post-merger HHI of 1,800 implies a market with 5.2 theoretically equivalent sized firms. The risk of adverse competitive effects when the number of competing firms moves from somewhere between ten to five plus, again seems relatively limited.

The 24 potential problem cases for which HHI data were included in the Determination includes very few instances where the post-merger HHI was below 1,800. One case, *CDG.AEPL*, which went to a Phase 2 investigation, had a post-merger HHI of 1,228 and a delta of just 18, although it is clear from the Determination that it went to Phase 2 because the Authority was unable to come to a conclusion regarding the relevant market during the Phase 1 investigation. Had it been in a position to do so, it seems unlikely that the case would have gone to Phase 2. *Greenstar/Veolia* went to Phase 2 although the post-merger HHI was below 1,000 in all of the relevant markets. It is unclear why a Phase 2 investigation was deemed necessary in that case. The majority of cases raising competition concerns had a post-merger HHI well above 1,800.

It is unclear what purpose is served for defining three different concentration zones. There would appear to be some merit in simplifying the system to provide that where the post-merger HHI is below 1,800 a merger would be unlikely to raise competition concerns and thus unlikely to require a detailed investigation. It could be worded in a way that would not rule out an investigation in the relatively unlikely event that competition concerns might arise in a case where the post-merger HHI threshold was below this level. The purpose of the delta is presumably to eliminate cases which involve a non-trivial increase in market concentration. A delta of 100 would seem appropriate to address this.

In our view, no real case has been advanced for raising the thresholds apart from the fact that the US thresholds have been revised. As noted, Australia and the UK have an upper threshold of 2,000 which is significantly below the US level. The Authority needs to consider whether it believes that it is necessary to have four firms or less in a market before unilateral effects could arise because that is what a threshold of 2,500 implies.

It is sometimes suggested that a higher threshold is justified because of the small size of the Irish economy. There is no justification for such an argument. The fact that an economy is smaller does not mean that a higher level of concentration is required before a merger would raise competition concerns. Rather it is inevitable that in a small economy, mergers may be more likely to raise such concerns.

Compecon therefore suggests that the Authority's HHI thresholds should be simplified to provide that a merger would be unlikely to substantially lessen competition where the post-merger HHI was below 1,800 or where the delta was less than 100. In our view there is no need to raise the threshold although a marginal increase to 2,000 would probably not make a great deal of difference. We do not believe that there is any case for raising the threshold beyond 2,000.

While concentration *per se* does not necessarily mean that a merger will reduce competition, it is worth noting that the HHI can provide some other useful information about the likely competitive impact of a merger. In *Stena/P&O*, for example, the merger effectively involved the sale by one party of a business to another, thus leaving the number of competitors unchanged, although the Authority noted that the level of market concentration declined. If the number of competitors remains unchanged but the HHI declines this means that market shares have become more symmetric, which might increase the risk of coordinated effects. In other words, it may sometimes be necessary to look beyond simple numerical changes in the value of the HHI and to consider the implications of such changes.

In order to calculate the HHI correctly it is necessary to have market share data for all of the participating firms and this is not always available. In the first place if there a number of small firms in a market whose combined market share is relatively small, e.g., less than 10%, the fact that one does not have individual market shares for them will not greatly distort the calculation of the HHI. One could simply assume that they are the same size, and the resulting estimate would be reasonably accurate. In addition, in many cases if one has rough market shares of the top three or four firms, that will suffice to establish if the HHI was likely to exceed a particular threshold such as 1,800 while one only needs the market shares of the merging firms to calculate the delta.

- In conclusion the HHI can provide a threshold for identifying cases which are unlikely to result in an SLC and such a screening device would appear beneficial for both the Authority and the merging parties.
- In addition, the HHI can provide a useful indication about market structure which can assist in the consideration of a merger.
- In our view the Authority's HHI thresholds should be simplified to provide that a merger would be unlikely to substantially lessen competition where the post-merger HHI was below 1,800 or where the delta was less than 100.
- In our view there is no need to raise the threshold although a marginal increase to 2,000 would probably not make a great deal of difference.
- We do not believe that there is any case for raising the threshold beyond 2,000.

4: Substantial Lessening of Competition.

The views expressed in the Consultation Paper on this point are rather confusing. The paper states:

"2.8 The 2002 Merger Guidelines should be updated to provide more clearly the context for Competition Authority's use of the SLC test. For example, at present, there is no linkage to the Act, whereas a clearer link to the Act would highlight the purpose and meaning of the SLC test.

2.9 Also in addition to a technical description of the SLC test, there should be greater emphasis on its role as a theoretical concept. This would clarify how the SLC test is used by the Competition Authority in forming its opinion on whether or not a proposed transaction will substantially lessen competition."

It then puts forward the following proposal:

"2.10 The 2002 Merger Guidelines could be amended to clearly:

define what is meant conceptually by the term 'substantial lessening of competition'; and

describe the role of the SLC test in the Competition Authority's merger review function (for example, by reference to Sections 21 and 22 of the Competition Act 2002 and/or any analogous sections in subsequent legislation)."

The discussion in paras 2.8 and 2.9 along with the proposal itself are far too vague to allow for any meaningful comment.

The Authority's existing Guidelines state that it interprets the substantial lessening of competition test in terms of consumer welfare. It has indicated that consumer welfare depends on a range of variables including price, output, quality, variety, and innovation. The Guidelines specifically state:

"In most cases, the effect on consumer welfare is measured by whether the price in the market will rise. The conclusion that an SLC will result from a merger is thus based on whether the price to buyers is expected to rise (or output to fall). Where price is not the appropriate variable, welfare is measured by the changes in the relevant variables."

Thus, the key issue from the Authority's point of view is whether or not the merger will result in higher prices. In effect therefore the test applied by the Authority might be regarded as a price test rather than a consumer welfare test. Nevertheless, the Guidelines are fairly clear and straightforward in terms of setting out the Authority's interpretation of when a substantial lessening of competition will arise. Arguably the Guidelines could hardly be simpler or clearer on this point.

It is not clear from the Consultation Paper what problem the Authority is seeking to address. The Consultation Paper therefore fails to set out any clear case for revising this aspect of the existing Guidelines. It is not possible to offer any meaningful comments without further information on the Authority's proposals.

5: Theories of Harm.

The Consultation paper states that the Authority's 2002 Merger Guidelines emphasise unilateral and coordinated effects as the main theories of competitive harm. It goes on to state that experience and advances in merger review have revealed other important theories of harm that might arise from a merger, although the paper does not specifically cite any such theories. It refers to the fact that vertical mergers have been addressed in detail elsewhere, most notably, in the November 2007 EU Commission Guidelines on non-horizontal mergers which the paper states *"have informed the Competition Authority's analysis of vertical mergers and would provide a valuable reference for updating the 2002 Merger Guidelines."*

The Consultation paper then proposes that:

> *"The 2002 Merger Guidelines could be amended to:*
> *provide a more detailed and nuanced description of the various theories of harm, addressing for example, harm from unilateral effects, co-ordinated effects, and effects from non-horizontal mergers and clearly state the importance of theories of harm to the Competition Authority's merger review function."*

This is an important issue which needs to be addressed by the Authority. There is a need to provide greater clarity in the Guidelines on various theories of competitive harm. More importantly, however, the Authority needs to place greater emphasis on theories of competitive harm in its merger analysis. Many of its decisions in respect of the limited number of cases that raised competition concerns do not put forward a clear theory of competitive harm which is being considered. Instead, the Determination sets out an analysis of various characteristics of the relevant market, e.g., closeness of competitors, countervail buyer power without setting them in the context of any competitive harm theory. Determinations have often focused on a particular unilateral effect's theory based on closeness of competition even though that theory would not appear to be appropriate to the particular case. In *Kingspan/Xtratherm*, for example, the Authority stated that the evidence indicated that the merging firms were each other's closest competitors even though it also stated that the products were homogenous. If products are homogenous then it makes no sense to talk of particular firms being each other's closest competitors.

The analysis of a particular merger which is considered to raise potential competition concerns should be conducted in the context of a specific theory or theories of competitive harm. The appropriate theory will depend on the nature and characteristics of the relevant market which serves to illustrate the importance of market definition.

The discussion of competitive harm theories in section 4 of the Guidelines is somewhat confusing. Para 4.4 starts with a good summary of unilateral effects. 4.5 then talks about how market structure is first examined. 4.6 outlines the next steps in the analysis and describes certain aspects of one particular theory of competitive harm, i.e., closeness of competition, and how it might be analysed, although the various theories of competitive harm are not described until para 4.13 *et seq.* The Guidelines would read better and be easier to follow and understand if they clearly described the various theories of competitive harm that apply to horizontal mergers and then followed this by describing the analytical steps that might be relevant in each case. A new section on non-horizontal mergers could then follow a similar approach.

As the Authority's Guidelines point out theories of competitive harm fall into two broad categories: unilateral and coordinated effects theories. The literature indicates that, as a general rule, unilateral effects are more likely to arise in the case of differentiated products while coordinated effects are more likely in the case of homogenous products. The literature also indicates that consumer goods are likely to be differentiated while in the cases where the customers are business, products are less likely to be differentiated. It could be helpful if this were reflected in the Guidelines.

In differentiated product markets unilateral effects can arise in several ways which are referred to in the existing Guidelines:

- The merger may create or strengthen a dominant position (Guideline's para
- 4.13)
- A merger of two close substitutes (Guideline's para 4.14 a)
- A merger changes the non-cooperative equilibrium and some or all of the firms modify their behaviour. (Guideline's para 4.4).

The Authority would not appear to have put forward a dominance theory in any of the problem cases which Compecon has identified, although arguably such a theory would appear to have been more appropriate in some of these cases that a closeness of substitution theory. It is sometimes suggested that the Irish legislation involves a substantial lessening of competition test rather than a dominance test. However, the issue is not the substantive test. Dominance is one of the scenarios under which unilateral effects may arise and this needs to be recognised.

The closeness of substitution theory is reasonably well explained in the Guidelines particularly in para 4.14a. The problem, however, is that some aspects of this theory are included in the earlier description of analytical steps that might be followed when analysing a merger in paras 4.6 and 4.7. It is also important to emphasise the point in para 4.7 that in such cases it is not sufficient to establish that the merging brands are each other's closest competitors to establish that non-merging brands do not exercise a sufficient competitive constraint. *"Also relevant is the ability of other firms to reposition existing products or brands or otherwise develop substitutes of sufficient homogeneity, substitutability, quality and status to overcome consumer stasis."* While this is recognised in the Guidelines, the Authority has not always adopted this approach in practice, most notably in *Kerry/Breeo*. The Authority needs to recognise that before coming to a definitive conclusion as to whether non-merging firms will exercise an effective post-merger competitive constraint it is necessary to consider whether such firms could reposition their products to make them closer substitutes to the merging brands. This would entail an assessment a number of factors including the likely costs involved in such repositioning and this needs to be expanded in the Guidelines.

The third scenario of a change in the non-cooperative equilibrium is not really analysed in the Guidelines at all, although the Authority effectively put forward such a theory of competitive harm in *Kingspan/Xtratherm* where it argued that it would be in the interests of the remaining non-merging firms to go along with any unilateral price increase by the merging firms. The justification advanced by the Authority for this conclusion appears questionable. For example, the remaining firms were much smaller than the merging firms which would imply that they would gain far more by trying to undercut them and increase their market share. The Determination also stated that the market was declining which again raises questions as the profits from competing on price would be likely to outweigh the future profits from going along with any price increase. Thus, the Authority needs to clarify the mechanism by which a merger would lead to a change in the non-cooperative equilibrium. In reality static Bertrand (differentiated) models indicate that a merger is always likely to result in a price increase by altering the non-cooperative equilibrium, i.e., it amounts to nothing more than saying that because a merger reduces the number of competitors the noncooperative equilibrium price is likely to increase. The issue then is whether dynamic factors will prevent such a price increase.

In the context of a change in the non-cooperative equilibrium, the Guidelines make a brief reference to the elimination of a *"maverick"* firm. (Paras 4.8 and 4.14e). There is no discussion about the role of a "maverick" firm in preventing a unilateral price and whether it would be a relevant factor in all unilateral effect's theories. For example, what would be the impact of a *"maverick"* in a dominance case or a closeness of substitution case. Interestingly the Consultation paper states at para 2.26 that *"effects of a merger involving a maverick firm are most relevant in the context of constraints on coordinated behaviour and coordinated effects."* The Guidelines need to be revised to clarify all of these points.

Unilateral effects may arise in homogenous product markets if the merged firm can raise prices post-merger by reducing output. In order to do so it is necessary that the remaining non-merging firms must be capacity constrained as otherwise it would be in their interest to increase output (and market share) thus negating the attempt by the merging firm to raise prices. This appears to be addressed in paras 4.14 b and c of the existing Merger Guidelines although the discussion is somewhat confusing. For example, 4.14b states that unilateral effects may arise where competitors are capacity constrained while 4.14c says they can arise where output or capacity is the strategic variable. It is not at all clear what distinction is being drawn between these two scenarios.

Para 4.14b goes on to observe that if the largest firms in a market are capacity constrained then it is possible that smaller firms with extra capacity could have market power. This implies that a merger of two relatively small firms could result in a substantial lessening of competition although it does not provide any further explanation. First it is not obvious why the smaller firms need to have spare capacity to act in this way. Arguably they could simply reduce output and thus raise price even if they did not have spare capacity. Second it is not entirely clear why it would be in smaller firm's interest to act in this way rather than to utilise the spare capacity to increase output and drive down price to gain market share. This scenario requires some further explanation.

4.14c states that the larger a firm's market share the more it would gain by cutting output and driving up price in such circumstances and then goes on to state that consequently a merger that increased a firm's market share would increase its incentive to raise price. The Guidelines state that this theory is known as the Cournot theory although it makes no reference to the fact that Cournot models apply to homogenous product markets. Again, the Guidelines could clarify that this scenario is likely to arise in the case of homogenous products.

In differentiated product markets, if the merging firms are each other's closest competitors, the fact that the remaining non-merging firms have spare capacity would appear to make little difference and is not normally considered in the analysis of such a merger. Theory indicates that in such a merger the customers of the merging firms are unlikely to switch to the products of non-merging firms in the event of a unilateral price increase which tends to reinforce the point that capacity constraint theories are largely relevant to homogenous product markets.

Para 4.7 is therefore particularly confusing in this regard.

> *"Third, the reactions of existing competitors are examined. Of central importance here is whether capacity or other constraints limit the ability of competitors to win sales if the merged firm increases its price. If competitors were not able to increase output to satisfy customers who switch, market power would result. Also relevant is the ability of other firms to reposition existing products or brands or otherwise develop substitutes of sufficient homogeneity, substitutability, quality, and status to overcome consumer stasis. This includes any firms identified during the market definition process as potentially able to supply the market at short notice (supply substitution), but that were not ultimately included in the market as their output could not meaningfully be brought into market share calculations. Any firm making the product for its own internal use (so-called "captive sales") may also*

be examined where the firm is capable of selling its product directly in the market."

In effect this paragraph combines different scenarios which arguably apply to different competitive harm theories. The issue of capacity constraints is more likely to arise in the case of homogenous products. As previously stated, if the non-merging brands are not close substitutes for the merging brands, the issue of capacity would not appear to arise. If certain non-merging brands were close substitutes or if they could reposition themselves to be close substitutes, then capacity could become an issue, but this needs to be clarified. Thus, a clearer description is required of the different scenarios under which capacity could become an issue. The issues of capacity and repositioning should be discussed separately. The Guidelines should also confirm that capacity is more likely to arise in the case of homogenous products.

Coordinated effects are more likely to arise in the case of homogenous products because coordination is easier in that case.[9] Analytical tools for predicting the likelihood of anti-competitive effects are less well developed in the case of coordinated effects than in the case of unilateral effects. Essentially the literature has identified a number of factors which may facilitate coordination. The existence of such factors does not mean that coordination will necessarily occur. It is also the case that not all of the relevant factors need to be present in any particular case, nor that they should all point in the same direction, i.e., in favour of a coordinated outcome, while in some cases the impact of particular factors is recognised as being ambiguous.[10] Rather the analysis of coordinated effects is based much more on a checklist type approach that involves establishing whether particular factors are present or not. The Guidelines could probably benefit from a more elaborate discussion of the factors that need to be taken into account in considering coordinated effects.

[9] In the case of differentiated products, for example, there would be greater scope for cheating through quality improvements etc. In the case of differentiated products, it might be easier to coordinate through market sharing than price.

[10] For a more detailed discussion see D. Scheffman & M. Coleman, *Quantitative Analysis of Potential Competitive Effects from a Merger*, Federal Trade Commission, Washington DC, 2003 and P. Rey, Collective Dominance and the Telecommunications Industry in P. Buigues & P. Rey (eds.), *The Economics of Antitrust and Regulation in Telecommunications* Edward Elgar, London, 2004.

The discussion on coordinated effects includes a discussion on the role of a *"maverick"* in para 4.24. This states *inter alia.*

> *"For example, in a market with significant capacity constraints, a firm with particularly large capacity may be more likely to deviate, due to its greater facility to increase sales in any given period."*

This view seems inconsistent with paras 4.14c which argued that in a market where firms are capacity constrained a firm with a large market share would have an incentive to reduce output and raise price. It is also difficult to square with para 4.14b which argued that in such a scenario small firms with spare capacity would also have an incentive to raise price. Why do incentives differ as between large and small firms?

The Guidelines state at para 4.25:

> *"Previous history in similar product and geographical markets is considered. Instances of previous collusion, where the characteristics of the market have not changed dramatically, may be seen as evidence that market conditions are conducive to coordinated interaction."*

The Authority has approved transactions in cases where it had brought proceedings against the parties alleging collusive behaviour, e.g., *Glanbia/CMP* and *M&J Gleeson/United Beverages* while in *Heineken/Scottish & Newcastle* it cited evidence of parallel pricing behaviour but offered no explanation of it. In light of those decisions para 4.25 of the Guidelines requires clarification.

Finally, the existing Guidelines are largely silent in terms of outlining competitive harm theories that may arise in the case of non-horizontal mergers. Thus, the inclusion in the Guidelines of an analysis of such factors would be welcome.

Overall, in our view a clearer exposition of competitive harm theories in the Guidelines would be welcome. Indeed, it follows from the views outlined above that this aspect of the Guidelines requires quite extensive revision and elaboration. This should recognise that competitive harm theories depend on the nature of the market under consideration. In particular it would help if the link between the nature of the products, i.e., differentiated or homogenous, and various competitive harm theories was set out.

While the existing Guidelines are reasonably clear in their explanation of certain theories, e.g., closeness of competition, they are vague and imprecise in respect of others, e.g., spare capacity, change in the non-cooperative equilibrium.

In our view, however, the Authority needs to go beyond providing a clearer exposition of competitive harm theories in its Guidelines and needs to review its analytical approach.

In particular, the Authority needs to recognise that identifying a theory of competitive harm should be at the core of its analysis in any particular case. In other words, the Authority should identify at an early stage in every case an appropriate theory or theories of competitive harm, e.g., are products differentiated in which case a unilateral effects theory is more likely to be appropriate and, if so, which unilateral effects theory, i.e., dominance or closeness of competition etc. This should be done before any consideration of the likely impact of various factors such as entry, countervailing buyer power etc. Indeed, it is essential to analyse the implications of such characteristics in the context of an appropriate competitive harm theory.

6: Failing Firms.

It is widely recognised in the literature and in practice in many jurisdictions that a merger, which would otherwise be anti-competitive, might not be considered anticompetitive if one of the parties involved would be likely to go out of business, i.e., it is a failing. Such cases are likely to be relatively rare because generally seek to acquire profitable businesses. The existing Authority Guidelines recognise that a merger might not substantially lessen competition in a market if part or all of the merging assets are certain to exit the market in the event of the merger not taking place. The Guidelines also note that firms might have an incentive to exaggerate the extent of its weakness and thus set out strict criteria which must be satisfied before such a merger can be permitted, namely:

- The alleged failing firm must be unable to meet its financial obligations in the near future;
- No possibility exists that the firm will be successfully reorganised under the process of Examinership;
- The firm has made good-faith and verifiable efforts to elicit reasonable alternative offers of acquisition that would keep its assets, both tangible and intangible, in the relevant market and be less of a threat to competition than the proposed merger. It must be shown that such efforts have resulted in the firms being unable to sell for a price in excess of the liquidation value of its assets; and
- Without the merger taking place, the assets of the failing firm would definitely exit the relevant market.

The Guidelines state that such conditions may rarely be met in practice.

The Consultation Paper proposes that:

> *"The 2002 Guidelines could be amended to:*
>
> *clearly indicate what constitutes a "failing firm" for the purposes of the Competition Authority's merger analysis (that is, a firm that, together with its assets, would exit the market in the absence of the merger thereby reducing the quantity or choices of goods or services available to consumers);*
>
> *identify any issues specific to failing firms that the Competition Authority would likely address (including, for example, whether failure and exit will necessarily occur in the absence of a merger); and,*

> *clarify that even if the target undertaking is a failing firm, it is not always necessary for the Competition Authority, in performing its merger review function, to assess whether criteria relevant to failing firms are met. For example, a merger involving a failing firm may be capable of being cleared on the basis of the SLC test alone."*

In our view the existing Guidelines would appear to largely address these issues and it is not clear what additions are being proposed. One would therefore need to see the details of any proposed changes in order to offer any meaningful comment on this point.

7: Competitive Constraints.

The Consultation paper is relatively brief on this point. It states:

> *"2.15 The 2002 Merger Guidelines should be improved and updated with more discussion of competitive constraints and illustration of how the Competition Authority assesses competitive constraints in its merger review function.*
>
> *2.16 A specific issue that should be addressed is the 2002 Merger Guidelines' reference to a 3% price increase for assessing the substitutability of products within a market. This approach is not consistent with current best international practice which does not specify the magnitude of a price increase as a measure of substitutability."*

The paper then proposes:

> *"The 2002 Merger Guidelines could be amended to:*
>
> *provide a more complete discussion of competitive constraints, within the context of competitive effects analysis; and*
>
> *remove the 3% figure in the context of describing competitive constraints from close substitutability of goods and services."*

A more detailed discussion of competitive constraints in the Guidelines would be welcome. Again, one would need to see the detail of what is proposed before commenting further.

Compecon notes the Authority's admission that the use of a 3% price threshold for assessing the substitutability of products within a market is not consistent with current best international practice. As far as we are aware, there is nothing in the economic literature that would provide support for such a test. Consequently, we agree with the proposal to remove this provision from the Guidelines. We note, however, that the Authority relied heavily on this point in concluding that private label brands would not exercise a sufficient competitive constraint on the merging brands in *Kerry/Breeo*.

8: The Counterfactual.

The Consultation paper proposes that the Merger Guidelines should be improved and updated to better describe the concept of the counterfactual which it describes as *"what will or might happen in the absence of the merger going ahead"*. In most instances the most likely alternative to the merger going ahead is a continuation of pre-merger competitive conditions. Nevertheless, there are some cases in which the continuation of the pre-merger status quo would not represent a realistic scenario.

The issue of the counterfactual featured in the *Herald/AM* case where the Authority stated that the notifying parties had put forward two alternative counterfactuals. The Authority's Determination stated that it had identified a third possible counterfactual. It is not clear from the Determination which of these alternatives scenarios was considered to constitute the appropriate counterfactual. The assessment of the counterfactual is not a matter of considering various possible alternatives. Rather only the most likely counterfactual scenario should be considered. It is also important to stress that the appropriate counterfactual in most cases will be the pre-merger situation.

The question of the counterfactual also featured in the *Heineken/Scottish & Newcastle* decision. In that case the Authority essentially had to deal with the acquisition of an Irish based brewer by a rival brewer. The acquisition was part of a larger international merger in which Heineken and Carlsberg acquired the target's parent and divided its business between them. That transaction was notified to the EU Commission and the Authority requested that the Commission refer the Irish part of the transaction to it which the Commission agreed to do. The Commission approved the remainder of the transaction. In the circumstances it was clear that the counterfactual to the transaction which was before the Authority proceeding could not be a continuation of the status quo. The target's parent had been acquired so if the merger did not proceed the obvious question was what would happen to the target firm. The Determination stated that there were a number of possible scenarios and identified two:

a. The target could have been acquired by a brewer which had licensed B&C to brew and market its products;

b. The target would continue but would no longer brew and market its former parent's brands.[11]

The Determination assumed, however, that, in the absence of the merger, the status quo would continue even though it was clear that this was the one option that could not occur. Either someone would have acquired the target, or it would have exited the market. The Authority justified treating the status quo as the counterfactual on the grounds that:

a. It did not know what would happen absent the merger; and
b. This was the worst-case scenario from a competition perspective so that if the transaction did not substantially lessen competition compared with the status quo then it would not do so under any alternative scenario.

Given that the continuation of the status quo was a non-runner, the appropriate counterfactual was the most likely alternative outcome. The Authority cannot rely on an argument that it does not know what will happen. Merger analysis is by its nature speculative and by definition the Authority does not know for certain what will happen in any case. It must decide what will be the most likely outcome. It is not clear that the scenario chosen by the Authority was the worst-case scenario from a competition perspective. Arguably a counterfactual that involved the acquisition of the target by another brewer would have been the worst-case scenario for assessing the impact of the merger, although it must be stressed that the appropriate alternative is not the worst case but the most likely one.

The Consultation proposes that the Guidelines could be amended to:

- describe the concept of the counterfactual;
- illustrate the importance of the counterfactual to the Competition Authority's merger review function, particularly for more complex cases (for example, failing firm cases); and,
- highlight the importance of identifying the relevant counterfactuals in considering a proposed transaction.

Compecon believes that amending the Guidelines in this way would be extremely helpful, subject to the caveats outlined above. Any amendment should make clear that only one

[11] This would essentially have resulted in the loss of a lager brand which accounted for 20% of the target's sales by volume.

counterfactual to the merger will be considered and that this will be the most likely alternative outcome, which, in the majority of cases, would amount to a continuation of the pre-merger status quo.

9: Entry.

The current Merger Guidelines' recognise that a merger is unlikely to substantially lessen competition in a sustained manner if entry into the market is sufficiently easy as to prevent a post-merger price increase. This is consistent with the economic literature and international best practice. The Guidelines provide that entry must be sufficient, likely and timely.

To be considered timely entry must normally be likely to occur within two years. This is in line with practice in other jurisdictions. Such a time limit appears reasonable. The longer the time-frame the greater the uncertainty that necessarily attaches to the likelihood of entry. In *Heineken/Scottish & Newcastle*, for example, the Authority accepted that the construction of a new brewery by *Diageo* was likely to prevent a unilateral price increase post-merger even though it was not due to come on stream until five years after the merger. Subsequently the proposal was put on hold which illustrates that the further into the future entry or expansion is expected to occur the greater the uncertainty involved. Compecon therefore believes that there is no good reason to extend the time frame for entry beyond two years, while recognising that in a limited number of cases, a longer time frame might be appropriate because of particular characteristics of the industry. In general this would arise where the lead time involved in bringing new facilities on-line is longer than two years.

The likelihood of entry ultimately depends on whether such entry is likely to be profitable at existing (or lower) prices. The Guidelines state that this depends on factors such as the level of demand at existing prices, whether demand was growing, the efficient scale of the entrant, whether the merger would result in output reductions, the entrant's ability to win sales, and expansion plans of incumbents. Thus the existing Guidelines provide a comprehensive list of factors that are relevant to assessing the likelihood of entry although the Guidelines say relatively little about how these factors will be analysed in practice. In particular there should be greater emphasis on quantitative analysis of such factors.

The third issue to be addressed is whether such entry would be sufficient to return prices to their pre-merger level. It is important to recognise that where multiple entry is likely the question is whether such combined entry would be sufficient rather than whether entry by each of them individually would be sufficient. The literature recognises that focusing on the sufficiency of individual entry in such circumstances will lead to the wrong conclusion.[12] In *Kerry/Breeo*, however, the Authority identified a number of potential entrants but concluded that entry by any of them individually would not be sufficient to prevent a post-merger price increase. The Authority needs to clarify in its Guidelines and amend its practice to recognise that such an approach is incorrect.

Compecon agrees with the view that entry should be timely, likely and sufficient.

- In our view to be considered timely entry should occur within two years.
- In our view a more quantitative analytical approach is required to the issue of likelihood.
- To be considered sufficient entry must be capable of restoring price to its pre-merger level. However, where there is a likelihood of more than one entrant, the analysis should focus on whether their aggregate entry would be sufficient to achieve this rather than individual entry by any one of them.

[12] M. Coate, Theory Meets Practice: Barriers to Entry in Merger Analysis, (2008) 4(1) *BE Online Journals Review of Law & Economics*, 183-212.

10: Countervailing Buyer Power.

The Consultation Paper states that the Authority's existing Merger Guidelines only offer a brief discussion of countervailing buyer power ("CBP"). It suggests that this could be improved by the inclusion of a more detailed discussion of CBP, together with a clear indication of how the Authority would assess the strength or otherwise of CBP. It proposes amending the Guidelines to include a greater level of detail regarding CBP including examples of situations in which buyers would, and would not, be able to exert CBP.

Compecon agrees that the discussion on countervailing buyer power in the existing Guidelines is relatively brief and that the Guidelines could be improved by the inclusion of a more expansive discussion on this issue. Para 4.10 states:
"The fact that buyers are large and have a degree of bargaining power is not sufficient to conclude that market power is effectively constrained. Effective buyer power requires that buyers have alternative sources of supply, or are capable of credibly threatening to set up alternative supply arrangements."
The Authority has considered the issue of countervailing buyer power in a number of cases, most notably in *Kerry/Breeo*. In that decision the Authority appeared to raise the threshold for establishing that countervailing buyer power would be sufficient to prevent a post-merger price increase by indicating that in order to exercise such power a customer would have to be capable of permanently replacing the merging brands. In *Heineken/Scottish & Newcastle* the Authority concluded that individual pubs would be able to exercise countervailing buyer without any consideration of where they would obtain alternative supplies.

- Large buyers may have sufficient bargaining strength to be able to resist any pressure for higher prices post-merger. Countervailing buyer power arises where "buyers, either because of their size or commercial significance to their suppliers, may have the ability to prevent the exercise of market power by suppliers".[13] The key issue is not the relative size of the buyers and the merged entity but whether such buyers could effectively refuse to buy at least for a time in the event of an attempted price increase. This means that they must be able to do without the product concerned, at least for a period of time. In effect this requires that there be other suppliers they can buy from or, at the very least, they must be able to delay making purchases in order to put pressure on the merged entity not to raise prices.[14] Factors that will affect the ability of buyers to constrain suppliers include:

- buyers' ability to find alternative suppliers in the case of a price rise;
- the ease with which buyers can switch supplier;
- the extent to which buyers possess a credible threat of setting up their own supply arrangements; and
- the extent to which buyers can impose costs on suppliers (for instance, by delaying purchases).

The UK Guidelines recognise that even where customers might have no choice but to purchase from the merging firms, they might be able to constrain price increases by imposing costs on the supplier, e.g., by refusing to purchase other products from that supplier or, in the case of retailers, positioning the supplier's products in less eye-catching parts of the store.[15]

In light of the Authority's decision in *Kerry/Breeo* the Guidelines need to be amended to recognise that it is not necessary for buyers to permanently replace the merging firms' products in order to exercise countervailing buyer power.

[13] Competition Commission, *Merger References: UK Competition Commission Guidelines, CC2*, paragraph 3.58.

[14] The essential point is that a merger is likely to lead to a price increase if, as a result of the merger, a price increase which would not have been profitable previously, becomes profitable. The point about countervailing buyer power is that it may be capable of rendering the price increase unprofitable and to do so does not require that buyers must be able to permanently replace the merging brands. Reducing, withholding or delaying orders for a period of time may be sufficient to render a price increase unprofitable.

[15] This again tends to emphasise the point that what is important is whether the buyer can impose sufficient costs on the supplier so as to render a price increase unprofitable.

11: Efficiencies.

Where a merger would otherwise likely result in higher prices, such effects may be offset if the transaction would generate significant efficiency gains. For example, if a merger lowers marginal cost sufficiently this may counteract the incentive to reduce output to raise price. The *Kerry/Breeo* case is the only case to date in which the Authority has addressed the issue of efficiencies.

The Consultation Paper states that the Guidelines should be improved and updated to better provide adequate guidance on the mitigating effect of efficiencies and to indicate how the Competition Authority would assess the effects of efficiencies. It proposes that the Guidelines could be amended to include a more complete discussion of efficiencies, including for example:

- consideration of the extent and probability of cost efficiencies;
- the evidence (including the level of specificity of efficiencies) that the parties should submit; and,
- the distribution of efficiency gains to consumers, staff and shareholders.

As previously noted, the Competition Authority has indicated that it interprets a substantial lessening of competition in terms of a reduction in consumer welfare which is primarily based on whether price is likely to increase. If that is the test then the issue with regard to efficiencies is whether they are passed on to consumers. The issue of staff and shareholders benefiting as a result of any efficiency gains would not appear to be an appropriate consideration in the context of a consumer welfare test.

The issue of efficiencies is addresses in paras 5.9-5.16 of the existing Guidelines. Efficiencies are thus dealt with far more extensively than a number of other factors in the Guidelines.

Para 5.9 acknowledges that any anti-competitive effects arising from a merger might be compensated for by improvements in efficiencies resulting directly from the merger. An increase in the price-cost margin resulting from a merger might be offset by a reduction in cost that leaves price unchanged. It states that the Authority uses a "net price test" by considering whether the price paid by consumers will rise or fall as a result of the merger. It notes that efficiencies might also increase cost heterogeneity thereby reducing the likelihood of coordinated effects.

Para 5.10 lists efficiencies that might be considered:

- Efficiencies that are likely to increase price rivalry (e.g. increase cost heterogeneity thus making tacit collusion more difficult, or enable two smaller firms to take on larger rivals);
- Savings relating to more efficient purchasing processes;
- Efficiencies that arise because competition is destructive (e.g., cherry picking) can be considered, although such arguments are likely to arise only in a very small number of markets;
- Efficiencies that arise because of network effects in demand (e.g., standardisation); and
- Efficiencies due to technology transfer.

Para 5.11 states that *"demand-side"* efficiencies are also considered. Such efficiencies result in either an increase in the demand for one or more of the merging products or the creation of a new product or set of products. It states, however, that economic theory has not yet provided clear analysis on the welfare effects of such efficiencies, and although they are considered, compelling evidence would generally be required that they would result in a lower net price for consumers.

Para 5.12 lists types of efficiencies that are generally not considered, namely:

- Savings due to the integration of administration or head office functions;
- Input price reductions related to buyer power;
- Efficiencies related to economies of scale and scope that do not involve marginal cost reductions; and
- Efficiencies that may reduce prices in one market but cannot compensate for price increases in another.

The Guidelines then go on to state in para 5.13 that, in general, efficiencies that reduce marginal (as opposed to fixed) costs are treated more sympathetically as it is more likely that part of any marginal cost reduction would be passed on to consumers as lower prices. It accepts that this may even apply in monopoly situations, although pass-through of cost reduction is generally higher the greater the degree of rivalry.

> *"Economic theory is less clear on the extent to which lower fixed costs are passed through as lower prices, especially if rivalry is not strong."*

The Guidelines go on to state that it must be demonstrated that there is a sufficient likelihood that any claimed efficiencies would be realised and note that efficiencies that might be credible in a rivalrous market might be considerably less credible in a market in which rivalry is reduced. Efficiencies must be sufficient not only to outweigh any increase in price-cost margins but to offset any higher uncertainties about whether they will be realised. In other words, if efficiencies are likely but not certain, and a price-cost margin increase is more certain, then the efficiencies would need to be larger to enable a conclusion that on balance net price is unlikely to be higher.

Para 5.16 provides that the burden for including efficiencies rests with the merging parties. In particular, it is necessary to show that any efficiencies:

(a) Must be directly achieved by the merger;

(b) Cannot be achieved by another less restrictive (of competition) means; and

(c) Will be achieved within a reasonable timeframe and with sufficient likelihood.

It also provides that the parties must demonstrate what incentives the merged firm would have to realise efficiencies where rivalry has been lessened. In addition, it states that because the parties have incentives to put efficiencies in the most optimistic light, it is necessary that claimed efficiency gains must be clearly verifiable, quantifiable, and timely.

Only efficiencies that are merger specific are taken into account. Consequently arguments that a merger will generate efficiencies due to economies of scale may not be persuasive as they might be achievable through organic growth. Similarly greater weight will generally be afforded to variable cost savings rather than reductions in fixed costs on the grounds that variable cost reductions are more likely to be passed on to consumers in the form of price cuts.

It is clear from the above that the existing Guidelines include fairly extensive guidance on the question of efficiencies and how they should be evaluated. In particular the current Guidelines would appear to comprehensively address the issue of the extent and probability of cost efficiencies. They also state clearly that any efficiencies must be sufficient to offset any price increase which is the relevant issue under a consumer welfare standard. There would, however, appear to be scope for providing further guidance on the evidence (including the level of specificity of efficiencies) that the parties should submit. This is particularly so given the Authority's view that the burden of proving efficiency claims rests with the merging parties. Nevertheless this requirement must be qualified somewhat. It must be recognised that merging parties are not in a position to exchange detailed cost and other data prior to a merger. In addition a firm may believe that it will be able to secure substantial efficiencies as a result of an acquisition. It may be difficult for it to make such arguments as it may need the cooperation of the management in the target firm in order to conclude the acquisition. In addition management in the target firm are unlikely to support such efficiency claims as they would tend to reflect badly on them.

While the existing Guidelines are reasonably comprehensive, the Authority's analysis of efficiencies in *Kerry/Breeo*, the only decision in which it has addressed the issue, was highly unsatisfactory and there is a need for the Authority to clarify its thinking on the analysis of efficiencies.

In its Assessment issued to the parties in *Kerry/Breeo* the Authority concluded that the parties' estimates of production and distribution efficiencies were biased upwards because the social benefits or savings would be less than the savings to the merging parties.[16] Social costs and savings are not relevant in the context of a consumer welfare or price test. The Authority's Determination, however, stated

[16] The Assessment is sent to the merging parties and outlines the reasons why the Authority believes the merger would result in an SLC. It is akin to a statement of objections.

> *"The Authority is not arguing for a wider industry welfare standard. The assessment in discussing certain of the savings did use perhaps infelicitously the terms 'social gains' and 'social savings'"* (Para 9.49)

This explanation lacks credibility. During the course of the oral hearing and in a subsequent written submission, Compecon pointed out that social costs and benefits were not the appropriate criteria against which to measure efficiencies in the context of a consumer welfare standard. At no stage did the Authority indicate that it had been misinterpreted or misunderstood.[17]

The Determination stated that the production cost savings were overstated because the price paid by Breeo to its external suppliers might have included a contribution toward the latter firms' fixed costs, whereas only reductions in variable costs should be taken into account. As Breeo had outsourced production, its variable cost was the price it paid to its suppliers. Therefore, whether or not this price included a contribution to its suppliers' fixed costs was irrelevant. If Kerry's variable costs were lower than the price paid by Breeo to its suppliers, then this represented a variable cost saving.

The Authority Determination concluded that the estimated efficiency savings, even if achieved, would be insufficient to prevent a post-merger price increase because they only amounted to around 1% of total retail sales in each of the relevant product markets. In unilateral effects cases the issue is whether the merged firm's marginal costs will fall sufficiently to offset any potential price increase, thus expressing savings as a proportion of total market sales is completely irrelevant. During the appeal the Authority submitted that because it was concerned with whether prices in the market would rise, it was appropriate to look at the savings as a percentage of total market sales. Again, it must be stressed that there is no economic basis for such a claim.

The Authority Guidelines provide that efficiencies must be merger specific. This is consistent with the relevant literature and with international best practice. The

[17] During the High Court appeal of this decision the Court heard that an e-mail from an external economist retained by the Authority to advise on the case sent the day before its final decision pointed out that because the Authority was only concerned with whether prices would rise or fall post-merger the arguments advanced in the Assessment referring to social costs and benefits were incorrect. It pointed out that transferring production from Breeo's suppliers to Kerry's facilities would yield cost savings from Kerry's perspective *"and that is what would influence Kerry's price."*

economic literature, however, indicates that the existence of theoretical alternative ways for merging parties to achieve projected efficiencies is not sufficient to establish that efficiencies are not merger specific. Rather alternatives ways of achieving efficiencies must be reasonably practical options for the parties from a business and commercial perspective. There may be very good reasons why firms choose to expand through acquisition rather than by increasing capacity.[18] Farrell and Shapiro, while suggesting that claims that efficiencies are merger specific should be viewed sceptically, nevertheless point out that competition agencies must make realistic assumptions about what alternative means exist for achieving efficiencies.[19] In the US efficiencies are only considered non-merger specific if the alternatives are *"practical in the business situation faced by the merging parties".* The competition agencies can only advance realistic alternatives not merely hypothetical ones.[20]

In our view the Authority in *Kerry/Breeo* found that the projected efficiencies were not merger specific on the basis of theoretical alternatives which were neither practical nor realistic. For example, it suggested that Kerry could achieve the specified cost savings by winning more contracts to produce private label and/or increasing its exports. Similarly it claimed that the distribution savings could be achieved if Kerry and Breeo established a distribution joint venture. Private label business is commonly shifted at very short notice and is thus highly uncertain making it very risky to invest in expanding capacity to supply such products. No supporting evidence was advanced to support the suggestion that Kerry could achieve efficiencies by increasing exports. The acquisition arose as a result of Breeo's decision to exit the relevant business and put it up for sale so the Authority's suggestion that the two firms could establish a distribution joint venture to achieve distribution efficiencies was again unrealistic. At the appeal the Authority argued that if such an argument were to be accepted it could open up the possibility that no anticompetitive merger could be blocked as the parties could always argue one of them had decided to exit the market. Such an argument is flawed.

[18] C. Goldman, M. Piaskoski, T. Woodgate, O. Gilman, B. Baxt, M. Randall, S. Downie & I. Knable Gotts, International Competition Network, Merger Guidelines Project, Chapter 6, p.5. Available at http://www.internationalcompetitionnetwork.org/library.aspx?search=&group=4&type=0&workshop=0&page=4 (Visited 6 January 2010).

[19] J. Farrell & C. Shapiro, Scale Economies and Synergies in Horizontal Merger Analysis, (2001) 67(3) *Antitrust Law Journal*, 685-710.

[20] M. Coate & A. Heimart, *Merger Efficiencies and the Federal Trade Commission 19972007*, Economic Issues Paper, Federal Trade Commission, Washington DC 2009.

The Guidelines state that greater weight is placed on marginal or variable cost savings rather than fixed cost savings. In *Kerry/Breeo*, however, the Authority failed to follow its Guidelines and decided that fixed cost savings should be disregarded completely.

In the first place the fact that theory is less clear on the extent to which fixed cost savings are passed on is not sufficient to justify the complete exclusion of fixed cost savings. It is also inconsistent with economic theory and international best practice. In the long-run all costs are variable so that fixed cost savings may influence price formation in the long-run. Some studies have found that a high proportion of firms take fixed costs into account in setting prices.[21] Froeb et. al. point out that non-linear pricing or long-term contracts could make it possible for fixed cost reductions to be passed on to consumers.[22] A review of 186 US merger cases found that the FTC considers reductions in fixed costs even if they do not lead to a reduction in prices in the short-term because they may benefit consumers in the long-run.[23]

In its legal submissions during the course of the High Court appeal the Authority also somewhat strangely argued that the assessment of whether efficiencies were sufficient to offset a possible price increase was not quantitative. It is difficult to understand how such an analysis could be undertaken other than on a quantitative basis. This is particularly so given that para 5.9 of the Guidelines states the Authority uses a "net price test" which considers whether the price paid by consumers will rise or fall as a result of the merger. The Guidelines need to clarify how the "net-price test" is applied in light of its legal submission in the *Kerry/Breeo* High Court appeal.

In our view the Authority needs to revise its Guidelines to clarify its position in light of its decision in *Kerry/Breeo*. Specifically it needs to:

- Confirm that, because the substantial lessening of competition test is concerned with the impact of a merger on consumer welfare, the appropriate test for

[21] Goldman et. al. 2004.
[22] L. Froeb, S. Tschantz & G. Werden, "Pass-through Rates and the Price Effects of Mergers," (2005) 23 *International Journal of Industrial Organization*, 703-15.
[23] Coate & Heimart, 2009.

efficiencies is whether the cost savings accruing to the merging firm are sufficient to offset any potential price increase;

- Confirm that social costs and benefits are not relevant;
- Confirm that expressing savings as a percentage of total market sales is irrelevant for establishing the sufficiency of cost savings;
- Recognise that the appropriate variable costs to be taken into account are the variable costs of the merging parties which means that where one of the parties contracts out production to a third party, its variable cost is the unit price it pays to that third party. The issue of whether or not that price includes a contribution to the third party's fixed costs is irrelevant;
- Indicate that in deciding whether or not efficiencies are merger specific, the only alternative ways of achieving efficiencies that will be considered are those that are practical in the business situation faced by the merging parties while theoretical alternatives will not be considered;
- Clarify its approach to fixed cost savings and in particular, to follow international best practice in this regard which suggests that fixed cost savings should be taken into account to some extent.
- Clarify how the "net-price" test is applied.

12: Maverick Firms.

The Consultation paper notes that the current Guidelines refer to maverick firms in a few places, mostly in the context of competitive effects but also in relation to market structure. It recognises, as previously noted that the issue of a maverick firm is most relevant in the analysis of coordinated effects. It proposes that the Guidelines could be amended to include a more complete discussion of the significance of maverick firms for merger review including that the loss of a maverick firm is most relevant in the context of potential coordinated effects.

Clarification and elaboration in the Guidelines as regards maverick firms would be welcome, particularly, in the wake of the Authority's decision in *Heineken/Scottish & Newcastle* where it concluded that the target firm was not a maverick despite the fact that it had regularly failed to increase its prices in line with the only two other firms in the market who, according to the determination, had repeatedly increased their prices by the same amounts at roughly the same time over a prolonged period. In particular the Guidelines should define quite clearly what constitutes a maverick and what are the essential criteria required to establish whether or not a firm is a maverick. In the *Heineken* decision the Authority argued that the fact that the other two firms had repeatedly increased prices by identical amounts at around the same time established that the target firm did not exercise a constraint on their pricing behaviour. This ignores the fact that in the absence of the target, the other two brewers might have increased their prices by even more.

The Guidelines need to clarify what is meant by a *"maverick"* firm and how the existence of such a firm affects the analysis under the various theories of competitive harm.

13: Remedies.

The Consultation paper states that the Competition Authority has applied remedies to address competition concerns arising from a number of mergers. It proposes that the Merger Guidelines should be developed further by including the Authority's approach to remedies, structural or behavioural, which are aimed at addressing competition concerns arising from a merger. Specifically the Consultation proposes:

> *"The 2002 Merger Guidelines could be amended to provide a more complete discussion of remedies including:*
>
> *Reasons why the Competition Authority might consider remedies as an alternative to blocking a merger; and,*
>
> *Illustration, possibly with examples from the Competition Authority's merger decisions which applied behavioural or structural remedies."*

Compecon agrees that the inclusion of such material in revised Guidelines would be helpful. As always, however, the devil is likely to be in the detail and so any final conclusion would depend on the exact wording of such provisions.