OFFICE OF FAIR TRADING

Mergers: substantive assessment

A consultation paper

October 2002

Part of a series of consultation papers about how the provisions of the Enterprise Bill will work in practice

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SUMMARY

The Enterprise Act 2002 (the Act) will make a number of changes to the system of UK merger control under the Fair Trading Act 1973 (the FTA). The two most significant changes will be:

- that in future the Office of Fair Trading (OFT), rather than the Secretary of State for Trade and Industry, will have power to make references of most merger situations to the Competition Commission (CC), and[1]

- that, in assessing whether mergers should be allowed to proceed, the OFT and the CC will apply a 'substantial lessening of competition' test rather than a 'public interest' test.

These guidelines have been prepared to inform the legal, economic, business, and academic communities of the OFT's intended interpretation of the criteria for reference, and in particular the substantial lessening of competition test. These guidelines will be updated from time to time in the light of practical experience of the application of the Act, and it is expected that future editions will contain examples, based on actual decisions, of the concepts described.

In practice, however, the change to the substantial lessening of competition test is expected to make little difference to how mergers are assessed. For some years, the effect of a merger on competition has been the primary consideration in decisions on whether to refer a merger to the CC, and in the CC's conclusions on mergers referred to it. Consequently, the Director General of Fair Trading's published advice on reference decisions, and the CC's reports on merger references, under the FTA regime provide useful insights into how the new test is likely to be applied.[2]

Comments on these draft guidelines are welcomed. Comments may be submitted in written or electronic format to the following address by 12 January 2003:

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[1] The exceptions to this principle are described in Part 10 of these guidelines.
[2] See www.oft.gov.uk/Business/Mergers/default.htm and www.competition-commission.org.uk/reports/report1.htm

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We plan to publish on our website all comments that are received in electronic format. If you do not wish your comments to be published, please so indicate when submitting them.

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1 INTRODUCTION

Purpose and scope of the guidelines

1.1 These guidelines are published pursuant to clause 103(1) of the Enterprise Act 2002 (the Act) to provide guidance to companies and their advisers on the criteria applied by the Office of Fair Trading (OFT) when considering whether to refer a merger to the Competition Commission (CC) for further investigation. Subject to certain limited exceptions, the OFT has a duty to refer a merger to the CC for investigation if it believes:

- that a relevant merger situation has been created, and
- that it is or may be the case that the merger has resulted, or may be expected to result, in a substantial lessening of competition within any market for goods or services in the UK.

1.2 These guidelines explain both what is meant by a 'relevant merger situation' and the OFT's interpretation of the 'substantial lessening of competition' test. The guidelines describe the circumstances in which the OFT has jurisdiction over mergers affecting competition in the UK (Part 2), explain the concept of a substantial lessening of competition (Part 3), and explain the principles for assessing the competitive effects of horizontal (Part 4), vertical (Part 5), and conglomerate mergers (Part 6). Further, these guidelines address the circumstances in which the OFT might exercise its discretion not to refer a merger to the CC for investigation (Part 7), describe the principles behind the OFT's consideration of undertakings offered in lieu of reference (Part 8), explain the application of the mergers provisions of the Act to regulated industries (Part 9) and the operation of the exceptional public interest and special merger situation provisions (Part 10), explain the Act's interaction with the European Community Merger Regulation (Part 11), and give contact details for obtaining further information (Part 12).

1.3 Information on procedural aspects of the UK merger control system, including guidance on the content of submissions to the OFT, will be included in *Mergers – OFT Procedural Guidelines*. These non-statutory guidelines will be published prior to implementation of the Act's mergers provisions.

1.4 The guidelines represent the policy and practice of the OFT at the present time. However, legal and economic thinking evolves, so these guidelines may be revised from time to time to reflect such developments. Further information on

OFT merger analysis may also be found in the published merger advices on the OFT's website (the address of which can be found in Part 12 of these guidelines).

Institutional structure

1.5 The Act assigns distinct roles to the OFT, the CC, and the Secretary of State for Trade and Industry (Secretary of State). How these roles inter-relate is summarised in the following paragraphs.

1.6 The **OFT** is a new corporate body established by the Act to carry out certain functions on behalf of the Crown. Under the Act, the OFT has a function to obtain and review information relating to merger situations, and a duty to refer to the CC for further investigation any relevant mergers which it believes may be expected to result in a substantial lessening of competition. The OFT also has a function of advising the Secretary of State on mergers which might fall within the scope of the public interest or the special merger situation provisions of the Act. If there has been a reference, the OFT has a duty to provide any relevant information to the CC. If asked to do so, the OFT may also advise the parties to an agreement whether restrictions therein are ancillary to a merger and hence excluded from the prohibitions in the Competition Act 1998.[3] In cases where a merger is being contemplated, the OFT can provide informal advice or confidential guidance to the parties involved. In proposed or completed mergers, the OFT can, either on its own account, or, in exceptional cases where so requested by the Secretary of State, negotiate undertakings in lieu of a reference to the CC. The OFT employs administrative, legal, economics and accounting staff to perform these functions and duties. The activities of the OFT in relation to mergers are co-ordinated by its Mergers Branch, part of the Competition Enforcement Division.

1.7 The **CC** is an independent body consisting of members with expertise in competition matters. The CC investigates mergers referred to it by the OFT (and occasionally by the Secretary of State) to determine whether there is a merger situation that qualifies for investigation and, if so, whether that merger results, or may be expected to result, in a substantial lessening of competition. The CC determines the outcome of merger cases referred to it by the OFT, and reports to the Secretary of State on those mergers referred to it by her. It has no authority to investigate any merger unless it has been asked to do so by the OFT or the Secretary of State under the relevant statutory power.

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[3] See OFT guideline *Exclusion for Mergers and Ancillary Restrictions* (OFT416) - www.oft.gov.uk/Business/Legal+Powers/ca98+publications.htm

1.8 The **Secretary of State** heads the Department of Trade and Industry (DTI) and has retained a role in merger decisions for certain newspaper transfers, and in certain public interest cases. The Secretary of State is also able to modify certain provisions of the Act, including those relating to jurisdictional thresholds and the level of merger fees. The Act also provides scope for the Secretary of State to intervene in mergers that do not qualify under the normal jurisdictional tests, where the target enterprise has access to confidential information relating to national security. These are known as special merger situations.

Contact with the OFT

1.9 Both proposed and completed mergers are covered by the legislation. Most cases considered by the OFT are still at the proposal stage. Although UK merger control law does not require that a qualifying merger be notified, generally it is in a company's own interests to inform the OFT about a prospective merger in advance, so that any decision about reference to the CC can be taken before the agreement has been concluded. There is always a risk that, if a reference is made after completion, the merged businesses might have to be separated should the CC find that the merger's operation gives rise to a substantial lessening of competition.

1.10 Contact details for the OFT's Mergers Branch are provided in Part 12 of the guidelines. Companies and their advisers are encouraged to contact the OFT early in the merger process to discuss the application of the Act to a merger situation.

2 WHAT IS A RELEVANT MERGER SITUATION?

2.1 The Act's definition of a 'relevant merger situation' covers several different kinds of transaction and arrangement. A company that buys or proposes to buy a majority shareholding or a significant minority shareholding in another company is the most obvious example, but the transfer or pooling of assets or the creation of a joint venture may also give rise to merger situations. The Act's provisions apply both to mergers that have already taken place and to those that are proposed or in contemplation.

Introduction

2.2 A merger must meet all three of the following criteria to constitute a relevant merger situation:

- two or more enterprises (broadly speaking, business activities of any kind) must cease to be distinct, or there must be arrangements in progress or in contemplation which will lead to enterprises ceasing to be distinct

- either the merger must not yet have taken place or have taken place not more than four months before the reference is made, unless the merger took place without public announcement and without the OFT being informed of it (in which case the four-month period starts from the announcement or the time the OFT is told), and

- either:

  – the UK turnover associated with the enterprise which is being acquired exceeds £45 million (known as 'the turnover test'), or

  – the enterprises which cease to be distinct supply or acquire goods or services of a similar kind and, as a result of the merger, together supply or acquire at least 25 per cent of all those particular goods or services of that kind supplied in the UK or a substantial part of it. This means that the merger must result in an increment to the share of supply or consumption and the resulting share must be at least 25 per cent. (This test is hereafter referred to as 'the share of supply test'.[4])

[4] The share of supply test is not to be confused with the evaluation of 'market share' used in the economic assessment of mergers (which is discussed in Part 4 below).

2.3 It is implicit in these criteria that at least one of the enterprises must trade within the UK.

2.4 In making a reference to the CC, the OFT (or the Secretary of State in public interest cases) need only believe that a relevant merger situation may exist. It is for the CC to determine in the course of its investigation whether the referred case amounts to a merger situation under the Act.

2.5 As a general rule, mergers that fall under the scope of the European Community Merger Regulation (ECMR) are excluded from review under the Act. (Further information on the interaction of EC merger control laws and the Act is provided in Part 11.)

Enterprises ceasing to be distinct

2.6 Two enterprises will 'cease to be distinct' if they are brought under common ownership or control.

Control

2.7 'Control' is not limited to the acquisition of outright voting control but includes situations falling short of outright control. The Act distinguishes three levels of control (in ascending order):

- Company A may acquire the ability materially to influence the policy of Company B (known as 'material influence')
- Company A may acquire the ability to control the policy of Company B (known as 'de facto' control), and
- Company A may acquire a controlling interest in Company B (known as 'de jure', or 'legal' control).

2.8 It is not only the size of a shareholding that determines whether the holder can materially influence the policy of the company concerned. Plainly, the distribution of the remaining shares is a key factor. Among other things that need to be taken into account are whether the holder has board representation or whether any agreements with the company enable the holder to influence policy. Special provisions in the constitution of the company - such as restrictions on voting rights or other veto rights - may also be relevant.

2.9 Nevertheless, a shareholding of 25 per cent or more generally enables the holder to block special resolutions; consequently, this proportion is likely to be seen as automatically conferring the ability materially to influence policy - even when all the remaining shares are held by only one person. But the OFT may examine any

case where there is a shareholding of 15 per cent or more in order to see whether the holder might be able materially to influence the company's policy. Very occasionally, a holding of less than 15 per cent could also attract scrutiny where other factors apply, such as where the shareholder has board representation and control rights. Board representation may be regarded as conferring material influence independently of the underlying shareholding. Equally, there are no precise criteria for determining when a shareholding gives the holder 'de facto' control of a company's policy; a view has to be taken case by case in the light of the particular circumstances.

2.10 A 'controlling interest' generally means a shareholding of more than 50 per cent of the voting rights in a company. Only one shareholder can have a controlling interest, but it is not uncommon for a company to be subject to the control (in the wider sense) of two or more major shareholders at the same time - in a joint venture, for instance. Thus, as explained in the preceding paragraph, a significant minority shareholder may be seen as being able materially to influence a company's policy even though someone else owns a controlling interest.

Acquiring control by stages

2.11 Should a shareholding that confers the ability materially to influence a company's policy increase to a level which amounts to 'de facto' control or a controlling interest, that further acquisition will produce another merger situation potentially liable to reference to the CC. The same applies to a move from 'de facto' control to a controlling interest.

2.12 In principle, therefore, if Company A acquires Company B in stages, this could give rise to three separate mergers: first, as Company A moves to material influence; then to 'de facto' control; and, finally, to a controlling interest. But further acquisitions of a company's shares by a person who already owns a controlling interest do not give rise to a new merger situation.

2.13 For the purposes of a merger reference, where a person acquires control of an enterprise (in any of the three senses described above) during a series of transactions within a single two-year period, the Act allows them to be considered as having occurred simultaneously on the date of the last transaction.

The turnover test

2.14 The 'turnover test' is satisfied where the annual value of the UK turnover of the enterprise being taken over exceeds £45 million. Where none of the enterprises remains under the same ownership and control - in a partnership merger, for example - the value of the turnover of the enterprise being acquired will be

calculated as the sum of the turnovers of the two enterprises ceasing to be distinct, less the turnover of the enterprise with the highest turnover.

2.15 In principle, the turnover test applies to the turnover of the acquired enterprise that was generated by customers within the UK at the time of completion of the merger or, if it has not yet taken place, at the time of reference to the CC. The figures in the enterprise's latest published accounts will normally be sufficient, unless there have been significant changes since the accounts were prepared. Where these do not provide a relevant figure, for example because only part of a business is being acquired, OFT will consider evidence presented by the parties and other interested parties to form its own view as to what it believes to be the value of UK turnover for jurisdictional purposes.

2.16 The basic principles set out above will be elaborated in specific guidance to be published by the OFT on the application of the turnover test.

The share of supply test

2.17 The 'share of supply test' is satisfied only if the merged enterprises:

- both either supply or acquire goods or services of a particular description, and
- will - after the merger takes place - supply or acquire 25 per cent or more of those goods or services, in the UK as a whole or in a substantial part of it.

2.18 Where an enterprise already supplies or acquires 25 per cent of particular goods or services, the test is satisfied so long as its share is increased as a result of the merger. It does not matter how small an increase that may be.

2.19 The Act allows wide discretion in describing the relevant goods or services, requiring only that - in relation to that description - the parties' share of supply or acquisition is 25 per cent or more. The share of supply test is not a market share test, thus the group of goods or services to which the jurisdictional test is applied need not amount to a relevant economic market. Generally, the OFT will have regard to the narrowest reasonable description of a set of goods or services to determine whether the share of supply test is met. This practice is intended to make it easier for companies and their advisers to determine whether the Act applies to a particular merger situation.

2.20 The share of supply test may be applied to the UK as a whole or to a substantial part of it. There is no statutory definition of 'a substantial part'. The House of Lords ruled in the context of similar provisions in the Fair Trading Act 1973 (FTA) that, while there can be no fixed definition, the area or areas considered

must be of such size, character and importance as to make it worth consideration for the purposes of merger control.[5] Factors which have been taken into account in cases considered under the FTA include the size, population, social, political, economic, financial and geographic significance of the specified area or areas, and whether it is (or they are) special or significant in some way. The OFT expects to take similar factors into account under the Act.

[5] See Regina v Monopolies and Mergers Commission and another *ex parte* South Yorkshire Transport Limited [1993] 1 WLR 23.

3 SUBSTANTIAL LESSENING OF COMPETITION

3.1 Save in certain limited circumstances, the OFT must refer a merger to the CC for further investigation where the OFT believes that it is or may be the case that the merger situation in question has resulted, or might be expected to result, in a substantial lessening of competition. Where the OFT has no such belief, the merger must be allowed to proceed. (There are three exceptions to the duty to refer which are described in Part 7.)

3.2 The test for reference will be met if the OFT has a reasonably held belief that, on the basis of the evidence available to it, there is at least a significant prospect that a merger may be expected to lessen competition substantially. The OFT considers that this standard of proof is the same as that against which FTA reference advices were prepared.

3.3 This part of the guidelines explains the general principles that the OFT will apply in seeking to identify mergers that it believes may be expected to result in a substantial lessening of competition. The OFT's interpretation of the concept of 'substantial lessening of competition' is first briefly explained, followed by an outline of the OFT's analytical framework. Later parts of these guidelines explain that framework in more detail, and also explain when the OFT may exercise discretion not to refer a merger to the CC for further investigation.

3.4 If the merger is a public interest case or a special merger situation, the Secretary of State may take other factors into account in deciding whether to clear or refer the merger.

Introduction to substantial lessening of competition

3.5 The OFT views competition as a process of rivalry between firms seeking to win customers' business. This process of rivalry, where it is effective, impels firms to deliver benefits to customers in terms of prices, quality, and choice. When levels of rivalry are reduced (e.g., because customers have fewer firms among which to choose or because of co-ordinated behaviour), the effectiveness of this process may diminish to the likely detriment of customers.

3.6 Not all mergers give rise to competition issues. First, many mergers are either pro-competitive (because they positively enhance levels of rivalry) or are competitively neutral. Second, some mergers may lessen competition but not

substantially, because sufficient post-merger competitive constraints will remain to ensure that competition (or the process of rivalry) continues to discipline the commercial behaviour of the merged firm.

3.7 A merger may be expected to lead to a substantial lessening of competition when it is expected to weaken rivalry to such an extent that the competitive process would no longer deliver a similar level of customer benefits as it would without the merger. In other words, with reduced market rivalry the OFT might expect that product choice would be reduced, prices could be raised profitably, output could be reduced and/or product quality or innovation could be reduced.[6]

3.8 The loss of competition should also be such that any of these post-merger effects would be expected to be sustained for more than a short period of time.

3.9 The core concept of the substantial lessening of competition test is a comparison of the prospects for competition with and without the merger. There are three basic merger situations that affect competition in different ways.

- **Horizontal mergers**. Mergers between parties that operate in the same relevant economic market can reduce competitive pressure on the merging firms to the extent that they could unilaterally impose a profitable post-merger price increase or otherwise behave anti-competitively. Other firms in the market might unilaterally raise their prices in response, without any collusion among participants. Also, a merger might increase the likelihood (or stability) of co-ordination, either tacit or explicit, between the firms remaining in the market.[8]

- **Vertical mergers**. Mergers between parties which operate at different levels of the supply chain of an industry, though often pro-competitive, may in some circumstances reduce the competitive constraints faced by the merged firm by foreclosing a substantial part of the market to competition (e.g., through refusals to supply, enhanced barriers to entry, raising rivals costs) or by increasing the likelihood of post-merger

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[6] These guidelines use the concept of 'market power' to describe the ability of a firm or group of firms to achieve these outcomes. It is of course possible that one party or both parties might have market power in advance of the merger.

[7] This could also encapsulate other modes of competition, such as competition in advertising, innovation or branding.

[8] Market power can also cover the exercise of monopsony, or buyer power. This may arise as a result of a merger where the merged entity attains such levels of buyer power that it can reduce the price it pays to suppliers to a level below the competitive price, leading to an anti-competitive reduction in suppliers' output. The OFT will apply an analytical framework analogous to that set out in these guidelines in assessing whether a merger creates, strengthens or allows the exercise of monopsony market power. In each, case, the loss of rivalry would need to be substantial.

collusion. This risk is, however, unlikely to arise except in the presence of existing market power at one level in the supply chain at least, or in markets where there is already significant vertical integration/restraints.

- **Conglomerate mergers**. Mergers between firms in different markets will rarely lessen competition substantially. But some such mergers might reduce competition, for example, through the exercise of portfolio power (which is explained in Part 6 below).

3.10 The application of the substantial lessening of competition test to these three types of merger is reviewed in later parts of these guidelines. Set out below is a summary of the broad analytical principles that the OFT will employ in seeking to identify mergers that may be expected to lessen competition substantially.

- The proper frame (or frames) of reference for analysing the immediate competitive constraints faced by the merged entity is identified by defining the relevant product and geographic markets affected by the merger.

- Characteristics of pre- and post-merger competition in the identified relevant markets may indicate concerns about a possible loss of rivalry as a result of the merger.

- Where a merger gives rise to possible competition concerns, entry by new competitors or expansion by existing competitors may be sufficient in scope, timeliness, and likelihood to deter or defeat any attempt by firms to capitalise on the loss of rivalry by exploiting customers.

- Other factors, such as buyer power, might constrain post-merger behaviour.

- Where one of the merging parties is thought to be failing, judgment of whether the merger would result in a substantial lessening of competition will take account of what would otherwise happen to the assets and business of that firm without the merger.

- Notwithstanding the loss of an independent market participant through the merger, rivalry within the market as a whole might be increased through the efficiency gains enjoyed by the merged entity.

3.11 The above principles should not be regarded as a mechanical framework for analysis. The process of identifying whether a merger might be expected to lead to a substantial lessening of competition considers the above factors in the round. Different factors may be given greater or lesser weight depending on the

details of a given case and, in many cases, it may not be necessary to consider all of the above factors. The following sections of these guidelines expand upon each of these factors.

Market definition

3.12 Proper examination of the competitive effects of a merger rests on a sound understanding of the competitive constraints under which the merged firm will operate. It is important to emphasise that market definition is not an end in itself. It is a framework for analysing the direct competitive pressures faced by the merged firm.

3.13 Relevant economic markets have two basic dimensions: products (or services) and geographic scope. The OFT has published a guideline on its methodology for identifying the scope of relevant product and geographic markets in cases under the Competition Act 1998.[9] Because broadly similar methodology is used to define markets in merger cases, reference should be made to previously published OFT guidance on market definition. The following discussion of market definition is accordingly brief.

Demand-side and supply-side substitution

3.14 Relevant market definition focuses on the empirical question of substitutability from the point of view of both customers and competing suppliers.

- **Demand-side substitution** examines the extent to which customers could and would switch among substitute products in response to a change in their relative prices.
- **Supply-side substitution** examines the extent to which suppliers of alternative products could and would switch their existing production facilities to make alternative products in response to a change in their relative prices.

3.15 Because the concepts of the relevant economic market aim to capture the most immediate constraints on anti-competitive behaviour, an important question in assessing the closeness of demand and supply-side substitution is the timeliness

[9] Office of Fair Trading, *Market Definition*, (1999) London: OFT; www.oft.gov.uk/Business/Legal+Powers/ca98+publications.htm

of customer and supplier responses to changes in relative prices. Only where such responses are relatively quick are the substitutes likely to be included in the relevant economic market.[10]

3.16 Similar questions of substitutability inform the assessment of geographic market. The more willing customers are to switch demand to firms located in a neighbouring area (or the more willing firms are to supply customers in neighbouring areas), the wider is the geographic market. The product and geographic dimensions of a market are often inter-linked. For example, customers' preferences for different brands might vary between regions or countries. Although the OFT's responsibilities under the Act cover the UK, the relevant geographic market may be wider or narrower than the UK.

Testing for market definition

3.17 The OFT's published guideline on market definition describes the various methodologies that the OFT uses to define markets. Set forth below are a number of general comments on market definition methodology. In defining markets, the OFT will have regard to previous OFT, CC and EC decisions concerning the same industry sectors and take due account of them, but does not consider itself bound by those precedents in particular because markets may change over time. Where appropriate, the OFT will also have regard to decisions of other competition authorities that concern the scope of the market(s) at issue.

3.18 One approach to assessing whether demand or supply-side switching is likely to discipline a price increase is the hypothetical monopolist test. Here, a market is defined by asking whether it would be profitable for a hypothetical monopolist to impose a small, but significant (five to ten per cent), non-transitory increase in price (the SSNIP test) on a given product or group of products. Starting from the product or products immediately affected by the merger, further products are added to the group until a price increase of five to ten per cent would be profitable because customers would not switch away from the postulated group of products in sufficient numbers. This approach is consistent with that in the OFT's published guideline on market definition.

3.19 The analytical framework of the hypothetical monopolist test requires consideration of a range of quantitative and qualitative evidence, which may include the following:

[10] This does not mean that longer-term demand and supply-side responses do not pose competitive constraints, nor does it mean that they are disregarded. For example, longer term supply-side responses are considered later in the context of entry conditions.

- evidence from customers, competitors and suppliers, including consumer surveys
- evidence of pricing strategies and relative price histories
- details of switching costs (customer and supplier), together with anecdotal evidence of switching, and
- existence of spare capacity (including capacity which could be readily switched).

3.20 Where the OFT is able to use quantitative price data as a basis for the hypothetical monopolist test, it will generally use prevailing market price data. This is because a merger investigation focuses on whether prices could be raised above current levels, rather than whether current prices are too high.[11] There may however be cases in which the OFT will use other than prevailing prices, for example where future market prices can be accurately predicted on the basis of, say, changes in an industry's price regulation.[12]

3.21 Where there are a number of similar products that are close substitutes, including where products are linked by a 'chain of substitution', some or all of those products may be included in the relevant economic market, according to the logic of the test. This same concept might also apply to neighbouring or overlapping geographic markets that are linked by a chain of substitution.

3.22 When determining what proportion of a supplier's capacity or production is available to compete for third-party business and thus may act as a competitive constraint in the open market, the OFT may disregard capacity or production that is committed internally. This is because committed capacity or production can generally only be switched to the open market (and thus become available to other customers) at a cost to the company's downstream activities that would not be outweighed by the additional profit made by the company on the additional upstream sales. The OFT may take captive capacity or production into

[11] In Chapter I and Chapter II investigations under the Competition Act 1998, the competitive prices version of the SSNIP test is used. An important aspect of these investigations is whether firms have market power. Where market power is being exercised, prices may be higher than they would be under competitive levels, and rival products may appear to be closer substitutes than they actually are (the 'cellophane fallacy'). In such a situation, if the SSNIP test were based on prevailing prices, one might erroneously conclude that the firm under investigation did not have market power. In other words, the fact that the firm under investigation had used its market power to raise prices above competitive levels might, in certain circumstances, lead to the conclusion that it did not in fact have market power.
[12] The fact that a firm currently has market power may still have relevance to merger inquiries.

account where that capacity or production could be readily and profitably switched to the free market in the event that the merged entity raised prices to third parties.

3.23 Market definition focuses attention on the areas of overlap in the merging parties' activities. This is particularly the case in differentiated products markets where the parties' products or services may not be identical, but may still be the competing alternatives for each other. In this context, the analytical discipline of market definition is helpful in identifying the extent of immediate competitive interaction between the parties' products. Once the overlap in the merging parties' products or services has been identified, along with the 'market' in which those products or service compete, we can focus attention on the competitive assessment.

Identification of the correct 'counterfactual'

3.24 As explained above, the core concept of the substantial lessening of competition test is a comparison of prospects for competition with and without the merger. The competitive situation without the merger is hereafter referred to as the 'counterfactual'.

3.25 In most cases, the best guide to the appropriate counterfactual will be prevailing conditions of competition. However, in certain circumstances, the OFT may need to take into account likely and imminent changes in the structure of competition in order to reflect as accurately as possible the nature of rivalry without the merger. Examples of such circumstances may include the following.

- In bidding markets, it is often more appropriate to consider which firms are likely to be feasible and credible bidders at the next round, than those who bid on the last occasion.

- Where a firm is about to enter or exit the market, this may be reflected in the counterfactual. [13]

- Where changes to the regulatory structure of the market, such as market liberalisation, or tighter environmental constraints, will change the nature of competition, the OFT will take account of this.

[13] The 'failing firm' defence reflects this concept. The OFT's treatment of failing firms is considered in more detail in Part 4 below.

4 ASSESSMENT OF HORIZONTAL MERGERS

Introduction

4.1 The focus of the OFT's competitive analysis is on evaluating how the competitive incentives of the merging parties and their rivals might change as a result of the merger. The starting point for this analysis is to review the changes in market structure resulting from the merger.

Market structure and concentration

4.2 The level of concentration in a market can be an indicator of competitive pressure within that market. Broadly speaking, the more concentrated the market, the weaker the competitive constraints on merging firms are likely to be. Similarly, the greater the increment to market share resulting from a merger, the more likely it is that the merger might lessen competition.

4.3 The three principal measures used by the OFT to examine market concentration and structure are described below. The choice of which measure to use will often depend on the availability of the data needed for each measure.

- **Market shares.** Shares are usually measured by sales revenue. Other measures, such as production volumes, sales volumes, capacity or reserves, may be used as appropriate. Current market shares may be adjusted to reflect expected and reasonably certain future changes, such as a firm's likely exit from the market or the introduction of additional capacity.[14] Historic market shares can also provide useful insights into the competitive dynamics of a market: for example, volatile shares might suggest that there has been effective competition.

- **Concentration ratios (CRs).** CRs measure the aggregate market share of a small number (usually three (C3) or four (C4)) of the leading firms in a market. They are absolute measures of concentration, taking no account of differences in the relative size of the firms that make up the leading group.

[14] Again, this reflects the core concept of the substantial lessening of competition test. It necessitates a comparison of the extent of rivalry in a market with and without the merger. As described above, the 'without the merger' situation does not always equate to the pre-merger world because of current and imminent market developments. In these situations, the pre-merger world must be adjusted to represent the world without the merger.

- **Herfindahl-Hirschman Index (HHI).** The HHI also measures market concentration, but takes account of the differences in the size of the market participants. The HHI is calculated by summing the squares of the market shares of all the firms engaged in the market. The increase in HHI (or delta) can be calculated by subtracting the market's pre-transaction HHI from the expected post-transaction HHI.[15] Both the absolute level of the HHI and the expected change in the HHI can provide an indication of whether a merger is likely to raise competition concerns. The OFT is likely to regard any market with a post-merger HHI in excess of 1800 as highly concentrated, and any market with a post-merger HHI in excess of 1000 as concentrated. In a highly concentrated market, a merger with a delta in excess of 50 may give rise to potential competition concerns. In a concentrated market, a merger with a delta in excess of 100 may give rise to potential competition concerns.

4.4 Each of these measures may be used as an initial indicator of potential competition concerns, but there will be no presumption that a merger may be expected to lessen competition substantially without further investigation. For example, in some markets – such as bidding markets – concentration measures may not accurately reflect the extent of competition for tenders. Equally, there is no presumption that a merger raises no substantial lessening of competition if the HHI data are lower than indicated above.

Possible anti-competitive effects of a horizontal merger

4.5 A horizontal merger is a merger between two firms active in the same market at the same level of business (e.g., between two manufacturers, two distributors, or two retailers). When horizontal mergers occur, competition may be affected in a number of ways. There is the loss of a competitor (actual or potential) and market concentration may increase.[16] The merger can change the competitive incentives of the merging firms, their rivals, and their customers, leading to changes in the intensity of competition. A merger can affect entry barriers and buyer power. The merging parties may themselves make efficiency gains as a result of the merger, and in some circumstances this could increase competition in the industry. To assess whether these changes will result in a substantial

[15] Thus, a market comprising firms a, b, c and d will have an HHI of $a^2+b^2+c^2+d^2$. The delta in this market resulting from a merger between firms a and b can be calculated as $((a+b)^2+c^2+d^2)$ - $(a^2+b^2+c^2+d^2) =$ Î . Hence, Î $= 2ab$.

[16] It is possible that a merger can reduce the level of concentration, e.g., when a firm with a high market share sells some capacity to a firm with a considerably lower market share or a new entrant.

4.6 lessening of competition, the OFT will consider whether the merger has any of these effects and, in light of this assessment, consider whether sufficient post-merger competitive pressure is expected to remain to ensure that the merged entity is not expected to be able to raise prices, reduce output, or restrict choice/innovation profitably.

4.7 There are two conceptually distinct ways in which a horizontal merger might be expected to result in a substantial lessening of competition: unilateral (single and multi-firm) effects or co-ordinated effects. It is possible that a single merger might raise concerns under both types of anti-competitive effects.

Unilateral anti-competitive effects

4.8 Unilateral effects may arise where, as a result of a merger, the merged firm finds it profitable to raise prices (or reduce output or quality) as a result of the loss of competition between the merged entities.[17] In other words, the merged entity's behaviour is profitable even if rivals continue to compete in the same way as they would have done absent the merger.

4.9 Unilateral effects may arise where the market (or markets) concerned have a number of the following characteristics.

- There are few firms supplying products that have the characteristics of the products supplied by the merging parties.
- The merger creates or increases a significant share for the merged firm relative to the shares of its remaining competitors, and the increment in market share as a result of the merger is substantial.
- The merging parties are close competitors representing for a substantial number of customers the 'next best alternative' to each other's products, so a merger between the two will prevent those customers from switching to the best rival product in the event of a post-merger price increase.[18]

[17] Where anti-competitive effects are unilateral, this does not mean that these effects are the product of action by a single firm: rather, 'unilateral' effects refers to independent or uncoordinated action by a firm or firms.

[18] Closeness of substitutability between the merging firms' products may be tested through assessment of price elasticities (i.e., the relationship between the volume of product sold and its own price (own-price elasticity) or the relationship between the volume of a product sold and the price of another product (cross-price elasticity)), diversion ratios (i.e., the proportion of sales of a product that may be lost to another product in the event of a price increase), other econometric techniques (where possible), customer preferences, or channels of distribution.

- Customers have little choice of alternative suppliers, whether because of the absence of alternatives, switching costs, or the ability of suppliers to price discriminate.

- It is difficult for rivals to react to changes in price, output or quality, e.g., through product repositioning or supply-side substitution.

- There is little spare capacity in the hands of the merged entity's competitors that would allow them to expand to supply customers in the event that the merged entity reduced output, and there is little prospect of expansion of existing capacity.

- There is no strong competitive fringe capable of sustaining sufficient levels of post-merger rivalry.

- One of the merging firms is a 'maverick' - an important rivalrous force in the market representing a competitive constraint greater than its market share indicates, whose elimination may thus be an important change in competitive dynamics.

- New entry is difficult, or where the merger itself increases the barriers to entry.

- One of the merging firms is a recent new entrant or a strong potential new entrant which may have had a significant competitive effect on the market since its entry or which was expected to grow into an effective competitive force.

- There is limited countervailing buyer power, or where the merger itself reduces pre-existing buyer power.

4.10 This is not a checklist of factors or characteristics that must all be present before unilateral effects are likely to arise. It is intended simply as a broad indication of the circumstances in which the OFT may consider the risk of unilateral anti-competitive effects to be high.

4.11 Though the profits from unilateral effects are generally captured by the merging parties, rival firms can also benefit from reductions in competitive pressure as a result of a merger. Even if rival firms pursue the same competitive strategies that they did prior to the merger, this can result in their increasing prices in the wake of a merger. In such cases, the firms in the marketplace are not co-ordinating their competitive behaviour (tacitly or explicitly): they are simply reacting independently to expected changes in each other's commercial behaviour. Such

instances of anti-competitive effects are still termed 'unilateral' by merger analysts since they are based on independent actions of firms. But it is important to recognise that the resulting price effects can be multilateral.

Co-ordinated anti-competitive effects

4.12 A merger situation may also lessen competition substantially by increasing the probability that, post-merger, firms in the same market may tacitly (or explicitly) co-ordinate their behaviour to raise prices, reduce quality or curtail output. This does not necessarily mean express collusion (which is generally an infringement of the Chapter I prohibition of the Competition Act 1998). Given certain market conditions and without any express agreement, tacit collusion arises merely from an understanding that it will be in the firms' mutual interests to co-ordinate their decisions. Co-ordinated effects may arise where a merger situation reduces competitive constraints in a market, thus increasing the probability that competitors will collude or strengthening a tendency to do so.

4.13 In order for tacit collusion to be successful or to become more likely, the OFT considers that three conditions must be met or be created by a merger:[20]

- the participants must have an ability to align their behaviour in the market
- the firms must have incentives to maintain the co-ordinated behaviour, which means detection of deviation from tacit collusion and credible 'punishment' of deviating firms by retaliatory behaviour by others, and
- the co-ordinated behaviour should be sustainable in the face of other competitive constraints in the market.

4.14 In appropriate cases, the OFT will examine whether each of these three conditions favourable to tacit co-ordination may be expected to arise. In this assessment, the OFT will review the structure of the market, its characteristics, and any history of collusion in the market concerned.

4.15 **Ability to align their behaviour in the market.** In order to collude tacitly firms need to achieve some kind of understanding as to how to co-ordinate. This need not involve an explicit agreement on what price to charge, market share quotas, or the quality of products to be attained. Nor is it necessary for the firms

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[19] For example, if the rival firm was subject to capacity constraints and essentially acting as a price follower, it will raise prices significantly post-merger. In another example, if competition takes place through sealed bid auctions, then a reduction in the number of potential bidders may cause all bidders to bid unilaterally higher prices.

[20] This approach is consistent with that taken by the Court of First Instance in its judgement in **Airtours v Commission**, Judgment of 6 June, 2002, not yet reported.

concerned to co-ordinate prices around the monopoly price, or for the collusion to involve every single firm in the market. However, it is sometimes possible for firms to find tacitly a 'focal' point around which to co-ordinate behaviour. Market transparency and stability are key elements in giving the firms the ability to align on terms of co-ordination.

4.16 **Detection and ability to punish**. Though tacit collusion is in the collective interests of the oligopoly, it is often in firms' short-term individual interests to 'cheat' on the tacit collusion by cutting price, increasing market share, or selling outside 'accepted' territories. If collusive behaviour is to be maintained, any such 'cheating' must be observable so that other firms have a credible threat of retaliating themselves. So, the market concerned should be sufficiently transparent that firms can monitor pricing and other terms of competition with a view to detecting cheating. Also, other firms must have a credible way of punishing any deviation from the tacit collusion, for example, by rapidly expanding output to drive down prices, by improving the quality of the product or service, or by advertising more intensively.

4.17 **Sustainability of co-ordinated behaviour.** Overall, the conditions of competition in the market should be conducive to tacit collusion in order to sustain the co-ordinated behaviour. Typically, this means that the market should be sufficiently mature, stable and with such limited competition (both actual and potential) that the collusion is not likely to be disrupted. For example, a strong fringe of smaller competitors (or perhaps a single maverick firm) might be enough to destabilise the oligopoly and render tacit collusion impossible.

Entry and expansion

4.18 Entry by new competitors or expansion by existing competitors may be sufficient in time, scope, and likelihood to deter or defeat any attempt by the merging parties or their competitors to exploit the reduction in rivalry flowing from the merger.

New entry

4.19 New entry, and the threat of entry, can represent important competitive constraints on the behaviour of merging firms. If new entry would be likely in response to any attempt by the merging parties to increase their prices, reduce their output, or reduce customer choice, then it is possible that the merged entity has no market power. Further, if entry conditions are particularly easy, then the mere threat of entry may be sufficient to deter the merging parties from raising their prices since any price increase or reduction in output/quality would incentivise that new entry to take place.

4.20 Before new entry (or the threat thereof) may be considered a sufficient competitive constraint, three conditions must be satisfied.

4.21 First, the OFT will examine whether new entry may be expected to occur in the event that the merging parties seek to exercise market power. In this regard, the OFT may review: barriers to entry to the market (or markets) to determine if new entry is in fact feasible; the experience of any firms that have entered or withdrawn from the relevant market or markets in recent years; evidence of planned entry by third parties; whether entry is likely given the costs of entering; and the minimum efficient scale needed for entry. Entry barriers may be broadly defined as any feature of a market that gives incumbent firms an advantage over potential entrants or control of the assets, such that incumbents can persistently raise their prices above (or reduce quality below) competitive levels without new firms entering the market. In assessing the extent of such barriers, we will consider absolute and strategic incumbency advantages, and the costs of entry.

- Absolute advantages include situations where government regulations, such as licensing, limit the number of competitors that are able to enter a market. Absolute advantages can also be derived from an incumbent's preferential access to essential facilities (e.g., take-off/landing airport slots at capacity-constrained airports) or intellectual property rights, or where the incumbent controls the assets necessary for the production or supply of the relevant products, such as natural resources.

- Strategic advantages arise where incumbent firms have advantages over new entrants because of their established position (first-mover advantages). For example, if an incumbent has made significant investments in an industry characterised by economies of scale, this may provide them with a credible incentive to charge low prices should a rival firm choose to enter. An entry barrier may also arise if incumbent firms are expected to behave strategically, for example, by responding to entry with very low prices or by investing in excess capacity or additional brands to deter entry.

- The fixed costs of entering a market are not entry barriers in themselves, but there are circumstances in which there can be entry barriers associated with fixed costs to the extent that these costs are sunk, i.e., the costs cannot be recovered if the entrant fails and is forced to exit. Sunk costs include set-up costs (such as market research, finding a location and getting planning permission) but may also include costs associated with investment in specific assets, research and advertising or other promotion costs.

- Economies of scale arise where average costs fall as the level of output rises.[21] In some circumstances, such scale economies can act as a barrier to entry, particularly where the fixed costs are sunk. In such situations, a new entrant may be deterred from attempting to match the costs of the incumbent by entering on a large scale, because of the risks that they would be unable to recover their sunk costs.

- The costs faced by customers in switching to a new supplier are also important in determining whether new entry would be an effective and timely competitive constraint.

4.22 Second, any new entry should be of sufficient scope to constrain any attempt to exploit greater post-merger market power. Small-scale entry, perhaps into some market niche, may be insufficient to prevent a substantial lessening of competition, even when the entry may be the basis for later expansion.

4.23 Third, the OFT would also need to be satisfied that any such prospective new entry would be sufficiently timely and sustainable to provide lasting and effective post-merger competition. Entry within less than one year will generally be timely, but this must be assessed on a case-by-case basis. In appropriate cases, a time period may be amended to reflect shorter or longer lead times for entry.

4.24 Analysis of entry conditions includes considering whether the merged entity would face competition from imports or supply-side substitution to the extent that these have not already been taken into account in market definition. What is important is that competitive constraints posed by imports and possible supply-side substitutes are counted in the analysis (whether they are counted under the label of market definition or that of entry).

4.25 The effect of a merger on the possibility and/or likelihood of new entry might itself contribute to a substantial lessening of competition where a merger increases barriers to entry or otherwise reduces/eliminates the competitive constraint represented by new entry. This might arise, for example, where the acquired entity was the most likely entrant: in other words, the merger would substantially lessen pressure from potential competitors.

[21] Economies of scope, where average costs fall the more types of products are supplied, may have similar implications to economies of scale

Expansion

4.26 The ability of rival firms in the market to expand their capacity quickly can also act as an important competitive constraint on the merging parties' behaviour. When considering the probability of such expansion as a response to price increases, the OFT will consider similar factors to those set out above for new market entry.

Buyer power

4.27 The ability of a merged entity to raise prices may be constrained by the countervailing power of buyers. It is possible to imagine a variety of different ways in which a powerful customer might be able to discipline supplier pricing.

- Most commonly, a buyer can simply switch – or credibly threaten to switch – its demand or a part thereof to another supplier. Whether buyers will maintain the same ability to choose among suppliers after the merger is a key issue.
- Even where a customer has (or customers have) no choice but to take the supplier's products, they may still be able to constrain prices if they are able to impose costs on the supplier, e.g., by refusing to buy other products produced by the supplier or by delaying purchases.
- Retailers may also be able to impose costs on the supplier through their own retail practices, e.g., by positioning the supplier's products in less favourable parts of the shop.
- Buyers might also threaten to enter the market themselves, or could sponsor entry by others by covering the costs of entry e.g., through offering the new entrant a long-term contract.[22]

[22] As such threats to change the market structure often involve making investments and incurring sunk costs, it may be possible for incumbent suppliers to raise prices to some extent before such threats become credible. Thus where the sunk costs of sponsoring entry are large, countervailing buyer power is unlikely to act as a strong competitive constraint. Buyers may also have a limited incentive to sponsor entry because the benefit of their investment is shared with their rivals and customers.

4.28 Overall, the key question is whether buyers will have a sufficiently strong post-merger bargaining position. The fact that buyers are large is not sufficient in itself for the OFT to conclude that buyer power exists. For example, even large customers may have limited scope to exercise buyer power against suppliers of 'must have' brands. Logically, buyers will also be constrained in their ability to exercise buyer power if there are no remaining alternative suppliers to which they could turn. To maintain competition constraints, buyers should also have an incentive to exercise their alleged power (because they may not always do so if other buyers would also benefit). Even if the buyer power of certain customers is not weakened the merged entity might still be able to exercise enhanced market power by discriminating against customers without buyer power.

Failing firm defence

4.29 As described above, merger assessment under the substantial lessening of competition test requires that prospective post-merger competition be compared with competition without the merger. Where one of the parties to a merger is genuinely failing, pre-merger conditions of competition might not prevail even if the merger were prohibited. The counterfactual might then have to be adjusted to reflect the likely failure of one of the parties and the resulting loss of rivalry.

4.30 In order to satisfy the failing firm defence against a finding of an expected substantial lessening of competition, the following three conditions need to be met. These three conditions will probably be met only in rare cases.

4.31 First, in order to rely on a failing firm defence, the firm must be in such a parlous situation that without the merger it and its assets would exit the market and that this would occur in the near future. These criteria will not often be met, even by firms on the verge of bankruptcy administration. Firms in liquidation will usually meet this criterion, however.

4.32 Second, there must be no serious prospect of re-organising the business. Identifying the appropriate counterfactual in these types of situation is often very difficult. For example, even companies in receivership often survive and recover.

4.33 Third, there should be no less anti-competitive alternative to the merger. Even if a sale is inevitable, there may be other realistic buyers which would be interested in obtaining the plant/assets should the merger not proceed: that could indeed be a means by which new entry can come into the market. It may also be better for competition that the firm fails and the remaining players compete for its share and assets than that the failing firm's share and assets are transferred wholesale to a single purchaser.

4.34 However, the OFT does not exclude the possibility that the acquisition of a failing firm, which results in a substantial lessening of competition, can result in consumer benefits - e.g., by ensuring that customers will continue to be supplied during the process of change or through commitments to honour existing warranties. Such benefits would need to outweigh the customer detriments which arise through the loss of competition. Customer benefits, and how they are assessed, are discussed in more detail later in these guidelines.

4.35 Information that the OFT would request in order to assess properly a failing firm defence may include evidence:

- that the company is indeed about to fail under current ownership
- that re-financing options have been explored and exhausted
- that there are no other credible bidders in the market, and that all possible options have been explored, and
- how the acquiring firm proposes using the failing firm's assets post merger.

Efficiencies

4.36 Efficiency gains are often claimed for mergers. The Act allows the OFT to take efficiency gains into account at two separate points in the analytical framework.

- First, efficiencies may be taken into account where they increase rivalry in the market so that no substantial lessening of competition would result from a merger. For example, this could happen where two of the smaller firms in a market gain such efficiencies through merger that they can exert greater competitive pressure on larger competitors. Efficiencies in this sense are discussed in the following paragraphs.
- Second, efficiencies might also be taken into account where they do not avert a substantial lessening of competition, but will nonetheless be passed on after the merger in the form of customer benefits. For example, if a merger would reduce rivalry in a market but proven efficiencies would be likely to result in lower prices to consumers, the OFT would not take this into account in reaching a conclusion on the substantial lessening of competition test, but it might be a consideration under the customer benefits exception to the duty to refer. Efficiencies in this latter sense are discussed in Part 7 of these guidelines.

4.37 Where efficiency gains are claimed to have a positive effect on rivalry, their impact can be assessed as an integral part of the substantial lessening of competition analysis. The key question is whether the claimed efficiency will enhance rivalry among the remaining players in the market: for example, where two smaller firms merge to provide more effective competition to a larger rival, or where the merger stimulates the combined firm to invest more in R&D and increase rivalry through innovation.

4.38 Efficiencies are defined broadly for purposes of these guidelines. Hence possible efficiencies may include cost savings (fixed or variable), more intensive use of existing capacity, economies of scale or scope, or demand-side efficiencies such as increased network size or product quality.[23] Efficiencies might also encompass pro-competitive changes in the merged entity's incentives, for example by capturing complementarities in, e.g., R&D activity, which in turn might increase incentives to invest in product development in innovation markets.

4.39 In order for the OFT to take account of claimed efficiencies, they must be: (a) demonstrable; (b) merger-specific; and (c) likely to be passed on to consumers.

4.40 First, demonstrable efficiencies are efficiencies that can be shown to arise clearly and incontrovertibly. Prospective efficiency gains are more easily claimed than achieved. The burden will therefore be on the merging parties to demonstrate efficiency gains that generally make rivalry stronger than it would be without the merger. Discharge of this burden will require compelling evidence.

4.41 Second, efficiency gains must be a direct consequence of the merger, i.e., they must be merger-specific. This does not imply that the merger needs to be the only conceivable way of capturing those efficiencies, but rather, because it is an incremental analysis, efficiencies must be judged relative to what would have happened without the merger.

[23] Efficiencies are more likely to be taken into account where they impact on marginal or variable costs, as such cost savings tend to stimulate competition and are likely to be passed more directly on to consumers in terms of lower prices (because of their importance in short-run price setting behaviour). Generally, savings in fixed costs will not be given such weight as they often represent private gains to companies and are not so important in short-run price formation. However, reductions in fixed costs can play an important role in longer term price formation (because they become variable in the long-run). Fixed costs can also be important in short-run price formation where, for example, competition takes place via auctions and bids reflect both the fixed and variable costs of the tendered service.

4.42 Third, the OFT must also be satisfied that there will continue to be sufficient post-merger competition within the market to ensure that the merged entity has an incentive not only to pursue the claimed cost savings but also to pass on to consumers a reasonable share of benefits.

4.43 The burden of proof is on the merging parties to show that claimed efficiencies will increase rivalry, are demonstrable, merger-specific, and likely to be passed on to customers. For the reasons set out above, the OFT is generally sceptical that efficiency gains benefit consumers, especially where there are few remaining competitive constraints on the parties.

5 ASSESSMENT OF VERTICAL MERGERS

Introduction

5.1 Vertical mergers are mergers between firms that operate at different but complementary levels in the chain of production and/or distribution. Vertical mergers are often efficiency-enhancing but, even so, they may still give rise to competition concerns in certain circumstances. In particular: is the merger expected to foreclose market access anti-competitively, or increase the ability and incentive of parties to collude in a market? Each of these issues is discussed below. However, common to both issues is the underlying theme that vertical merger concerns are likely to arise only if market power exists or is created in one or more markets along the supply chain.

Market foreclosure

5.2 A vertically integrated firm can in some circumstances foreclose rivals from either an upstream market for selling inputs or a downstream market for distribution or sales. Foreclosure does not mean simply that a vertically integrated firm is expected to exclude a non-vertically integrated firm from a market (though this may be the case), but may include a range of behaviour including refusal to deal, raising barriers to entry, and raising rivals' costs.

- If the merged entity is an important downstream customer for a product that it also supplies upstream, it may in certain circumstances be able to dampen competition from rival suppliers of that product by, for example, sourcing all of its future needs from its own production facility, thus jeopardising the continued existence of alternative upstream suppliers of the product.

- If a merged entity supplies a large proportion of an important input to a downstream process where it also competes, it may be able to dampen competition from its rivals in the downstream market for example by: diverting all its production of the input to its own downstream process;

- by refusing to supply to its downstream rivals; or by only selling the input to its rivals at a price that makes them uncompetitive.[24] This might be particularly relevant where firms in the downstream market need to stock a full range of products to be competitive; hence, the loss of any product could harm their competitive prospects.

- If the merged entity controls an important means of distribution to a downstream market, it might be able to reduce competition from its rivals by refusing to give them access to that means of distribution, or by granting access only at discriminatory prices that favour the merged entity's own business, thus placing rivals at a cost disadvantage.

5.3 The OFT will be concerned where, in any of the above situations, rivals lack a reasonable alternative to the vertically integrated firm. In this circumstance, rivals may either be deprived of access altogether or might be allowed to obtain the product or the facility only at unfavourable prices, thereby lessening rivalry in the market.

Increased potential for collusion

5.4 In rare cases, vertical integration may in certain circumstances facilitate collusion by increasing market transparency between firms.[25] Such concerns may arise, for example, where vertical integration affords the merged entity better knowledge of selling prices in another market, which facilitates tacit collusion in that market.

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

[25] See Part 4 above for a discussion of collusion as a result of horizontal mergers. The same concepts apply here: alignment, market transparency, monitoring of adherence to the collusion strategy, punishment of deviations, and competitive conditions conducive to collusion.

6 ASSESSMENT OF CONGLOMERATE MERGERS

Introduction

6.1 Conglomerate mergers involve firms that operate in different product markets.[26] They may be product extension mergers (i.e., between firms that produce different but related products) or pure conglomerate mergers (i.e., between firms operating in entirely different markets). Such mergers rarely lead to a substantial lessening of competition as a result solely of their conglomerate effects. In a small number of cases, however, potentially adverse effects can be identified related to so-called 'portfolio power'.

6.2 When the market power deriving from a portfolio of brands exceeds the sum of its parts, a firm is said to have 'portfolio power'. This may enable the firm to exercise market power in individual markets more effectively, with the result that competition is substantially lessened. Portfolio effects may directly affect market structure, increase the feasibility of entry deterrence strategies and/or eliminate the competitive constraint imposed by firms in neighbouring markets.

Effect on market structure

6.3 Suppose, for example, that a merger creates a firm with many brands under its control. This circumstance may substantially lessen competition if non-portfolio competitors, or those competitors that control only one or a few brands, do not impose an effective competitive constraint on the firm(s) with 'portfolio power', thus enabling the merging firms to increase price, reduce output or reduce product quality. These circumstances will only arise where customers have a strong incentive to buy from a single source rather than from many suppliers, and where the competitive constraints in the marketplace are insufficient to ensure that firms with portfolios of brands pass the benefit of their increased efficiency through to customers.

[26] Mergers between firms that are active in the same product market, but which sell in different geographic markets are sometimes termed conglomerate mergers. However, for the purposes of these guidelines, the OFT will consider these mergers as a type of horizontal merger since the competition analysis of such mergers could well focus on whether the merger eliminates a potential entrant to each geographic market.

Increasing the feasibility of entry deterrence strategies

6.4 Large conglomerates may seek to require customers to purchase a range of their products, whether through tying or bundling of products or through significant discounts targeted at non-portfolio rivals' customers. A merger may make tying or bundling more likely if the merged firm controls complementary goods. Such conduct is likely to result in adverse effects only if it would be difficult for rivals or new entrants to provide competing bundles and thus be unable to constrain the behaviour of the merged entity.

6.5 In rare cases, a conglomerate merger may also make predatory behaviour more feasible, especially where competition is localised so that firms only face a competitive threat on a few brands or a few geographic markets at any one time. A firm may be able to provide an aggressive response to entry or to induce exit by using profits earned in one market to subsidise short-run losses in another market. This may substantially lessen competition if the likely long-run outcome is a more concentrated market. Such behaviour is likely only when the merging firms already have market power in some markets and where barriers to entry are already relatively high, so that the short-run losses can be recouped by higher prices in the long run.

Increased potential for collusion

6.6 Finally, conglomerate mergers may facilitate collusion, especially if the merged firm's rivals in one market are also rivals in at least one of its other markets and if other factors facilitating collusion are also present in these markets.

7 EXCEPTIONS TO THE DUTY TO REFER

7.1 The OFT has a duty to refer a merger to the CC for further investigation where the OFT believes that it is or may be the case that the merger situation in question has resulted, or might be expected to result, in a substantial lessening of competition. There are three circumstances in which the OFT may exercise discretion not to refer such a merger. These are where the OFT believes that:

- the merger in progress or in contemplation is insufficiently advanced to warrant reference
- the market or markets in question are not of sufficient importance to warrant the making of a reference, or
- the customer benefits of a merger would outweigh its adverse effects.

Merger insufficiently advanced

7.2 The intention of this provision is to avoid the unnecessary expense of investigation where it is still uncertain whether the parties will proceed with the merger. In such circumstances the parties should not be inhibited from seeking informal advice or confidential guidance from the OFT.

7.3 The OFT would usually expect a transaction to be sufficiently advanced to justify an initial investigation where:

- the parties to a transaction have publicly announced a completed merger or their intention to merge (in whole or in part), or
- one of the parties to a proposed transaction has announced an intention to make an offer for the other notwithstanding that this may be subject to conditions or be a hostile bid.

7.4 In practice, the OFT would take a view early in an investigation that no real competition analysis is required because of the early stage of proceedings.

Markets of insufficient importance

7.5 The OFT may decide not to refer a merger if it believes that the market or markets in question are not of sufficient importance to justify the making of a reference. The purpose of this provision is to avoid references being made where the costs involved would be disproportionate to the size of the markets concerned. This exception is likely to apply only very rarely.

7.6 Particular circumstances in which mergers in very small markets might nevertheless be considered to warrant reference include the following:

- where the product concerned is an important input into a larger market
- where the market is growing quickly, such that current market size is not a good reflection of the actual or potential importance of the market. This may apply, in particular, to new technology markets
- where the goods or services concerned are considered essential to vulnerable consumers
- where the market is one of many smaller or local markets (for the goods or services concerned) that are together of considerable significance, or
- where the outcome of the case in question is likely to be of relevance to other cases/markets.

Customer benefits

7.7 For the OFT to exercise its discretion not to refer a merger on this basis, the claimed customer benefits must be clear and quantifiable.[27] Moreover, the OFT must believe that the claimed benefits will materialise within a reasonable period of time and must believe that such benefits would be unlikely to arise without the merger.

7.8 It is not sufficient to demonstrate that there are merely some benefits to consumers: such benefits must be passed on to consumers and must also be sufficient to outweigh the competition detriments caused by the merger. Illustrations of situations where such customer benefits might be weighed against the identified loss of competition include the following.

- **Lower prices**. A merger may – despite leading to a substantial lessening of competition – give clear scope for large cost savings through economies of scale. Even though price-cost margins might increase as a result of the substantial lessening of competition, these cost savings could in rare cases be significant enough to lead to lower prices after the merger. However, the cost-savings would need to be passed through in

  good part to consumers for there to be overall customer benefits, which presupposes that sufficient post-merger competition or buyer power remains.

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[27] 'Customers' include those who are customers of the parties to the merger, as well as intermediate customers, end-consumers, and future customers.

- **Greater innovation.** A merger might, in rare cases, facilitate innovation through R&D that could only be achieved through a certain critical mass, especially where larger fixed (and) sunk costs are involved. Exceptionally, the benefits likely to be passed through to customers from such innovation might outweigh the substantial lessening of competition.

- **Greater choice or higher quality.** One situation in which benefits of this kind might arise is that where a merger increases the size of a network, and thus its value to consumers, by making compatible what would be otherwise incompatible products.

7.9 The claimed customer benefits must accrue to customers of the merging parties (or to customers in a chain beginning with those customers), but need not necessarily arise in the market(s) where the substantial lessening of competition concerns have arisen. It is therefore conceivable that sufficient customer benefits might accrue in one market as a result of the merger that would outweigh a finding of substantial lessening of competition in another market(s). That said, the OFT's normal expectation is that these customer benefits will arise in the market where the competition concerns have been identified. To show that benefits in one market outweigh an expected substantial lessening of competition in another will require a very high standard of proof.

7.10 As noted in Part 4 above, efficiency claims may fall for consideration in the substantial lessening of competition test and/or subsequently in relation to the customer benefits tests. To count as customer benefits, by definition, customers need to be better off with the merger, despite the fact that the OFT believes that the merger might lessen competition substantially. These will be rare cases since, ordinarily, we would expect competition to deliver lower prices, higher quality and greater customer choice. The OFT does not expect to be sufficiently confident of customer benefits to clear mergers that it believes may or may be expected to result in a substantial lessening of competition except on rare occasions.

8 UNDERTAKINGS IN LIEU OF REFERENCE

8.1 The Act allows the OFT (or the Secretary of State in public interest cases) to accept binding undertakings from the merging parties as an alternative to making a reference to the CC.

8.2 The OFT can only accept undertakings in lieu of reference in cases where it has concluded that the merger should be referred to the CC. Such a conclusion must be published and the reasons for reference identified. Any undertakings must be aimed at remedying or preventing the adverse effects identified. In negotiating any such undertakings, the OFT will seek to achieve undertakings in lieu that are sufficient and proportionate to address clearly the expected adverse competition effects. The OFT will also seek to agree undertakings that preserve any merger-specific customer benefits.

8.3 In order to accept undertakings in lieu of reference, the OFT must be confident that the competition concerns identified can be resolved by means of undertakings without the benefit of further investigation. Undertakings in lieu of reference are therefore appropriate only where the competition concerns raised by the merger and the remedies proposed to address them are clear cut.

8.4 Undertakings in lieu have typically been used in merger cases in the past where a substantial lessening of competition arises from an overlap that is relatively small in the context of the merger (e.g., a few local markets affected by a national merger). In such cases the company may be willing to resolve the problem by divesting itself of part of its business (a structural undertaking); alternatively, in order to remove the concerns that have been raised, it may give a formal commitment about its future conduct (known as behavioural undertakings).

8.5 An acquiring company can always take the initiative to propose suitable undertakings if it thinks that they may be appropriate to meet any competition concerns that it foresees. Alternatively, the OFT may invite companies to consider whether they want to offer undertakings where it believes that it is or may be the case that a merger may raise competition issues potentially warranting reference and which seem amenable to remedy by undertakings in lieu.

Structural undertakings

8.6 A merger involves a structural change to a market. A structural solution will therefore often be the most appropriate remedy if the OFT believes that it is or may be the case that a merger may (or may be expected to) result in a substantial lessening of competition.

8.7 Typically, structural undertakings require the sale of one of the overlapping businesses that have led to the concern about competition. Ideally, this should be a self-standing business, capable of being fully separated from the merging parties. The sale should be completed within a stated period (usually a maximum of six months). An independent trustee may be appointed (at the owner's expense) to monitor the operation of the business pending disposal or to handle the sale if the owner has not completed the divestiture within the specified period. The OFT considers that structural undertakings are more likely to be accepted as undertakings in lieu than behavioural undertakings because they clearly address the market structure issues that gave rise to the competition problems.

Behavioural undertakings

8.8 Behavioural undertakings can provide a means of moderating the scope for a merged company to behave anti-competitively. The OFT will consider behavioural undertakings where it considers that divestment would be impractical, or disproportionate to the nature of the concerns identified. However, given that structural undertakings are more likely to remedy any competition concerns identified since they address structural changes in the marketplace from which the competitive effects flow, the OFT will probably not often consider that behavioural undertakings are sufficiently clear to address the identified competition concerns.

8.9 In public interest cases (discussed in part 10), which fall to the Secretary of State for decision, the OFT will consider whether the competition issues that arise are such that the OFT would recommend a reference if there were no public interest issues. If so, the OFT will consider whether or not these concerns could be resolved by undertakings and will advise the Secretary of State accordingly. The Secretary of State will have regard to the OFT's view on competition issues, but may decide that public interest issues require a different outcome to that which would pertain if there were no such competition issues. This could include a decision to clear the merger, a decision to make a reference, or a decision to accept undertakings, which might be different from those proposed by the OFT to resolve competition concerns.

Exclusion for mergers and ancillary restrictions from the prohibitions of the Competition Act 1998

8.10 Agreements and conduct that give rise to a merger, as well as any restrictions that are directly related and necessary to the implementation or the attainment of the merger ('ancillary restrictions'), are generally excluded from the prohibitions in the Competition Act 1998. This is the case whether or not the merger qualifies for consideration under the Act. The aim of the exclusion is to prevent agreements or conduct from being subject to control under both the Competition Act and the merger provisions of the Act, and to prevent agreements giving rise to mergers from being subject to control under the Competition Act when it was not thought necessary to control them under the merger provisions of the Act. However, to ensure that the exclusion does not allow significantly anti-competitive transactions to escape scrutiny altogether, it can be withdrawn in certain limited circumstances. These issues are set out in more detail in the OFT guideline *Exclusion for Mergers and Ancillary Restrictions* (OFT416).

9 SPECIAL PROVISIONS FOR MERGERS IN CERTAIN INDUSTRIES

9.1 Special provisions apply to mergers involving certain industries, specifically newspapers and water and sewerage undertakings. This part also discusses the role of sectoral regulators in mergers concerning those that they regulate.

Newspapers

9.2 The assessment and clearance of newspaper mergers are presently the responsibility of the Secretary of State under the FTA, although proposals for change are being considered.[28] The Secretary of State's prior written consent is required for any merger which concentrates, in the hands of one newspaper proprietor, newspapers with an average paid-for circulation of 500,000 copies or more per day of circulation. A 'newspaper proprietor' is any person who either owns a newspaper or controls directly or indirectly at least one-quarter of the voting rights in a company owning a newspaper. Except in certain limited circumstances, the Secretary of State cannot give consent to the transfer of ownership of the newspaper until the CC has investigated and reported on the proposed merger: there is therefore an automatic reference to the CC in most newspaper cases. It is a criminal offence to proceed with a newspaper merger without consent, or to breach any conditions attached to consent.

9.3 Under these arrangements, the OFT is not involved in analysis of newspaper mergers unless such a merger falls outside the special provisions and satisfies the general requirements of the mergers provisions of the Act.

9.4 A newspaper merger may sometimes be linked in the same transaction to the merger of non-newspaper businesses. In such circumstances, the Secretary of State may make parallel references of both mergers. But, where only the newspaper element of such a dual merger is referred, the CC investigation would not normally consider any non-newspaper aspects of the transaction unless they had a direct bearing on the newspaper merger.

[28] The Communications Bill and accompanying White Paper envisage that, in the future, the competition aspects of newspaper merger analysis will be handled by the OFT. Broader public interest considerations, such as plurality of the media, will continue to be handled by the DTI with assistance from Ofcom. The overall framework for these analyses is expected to follow the public interest framework in the Act described in the next part of the guidelines.

For advice on newspaper mergers, contact:

Consumer and Competition Policy Directorate,
Department of Trade and Industry
1-19 Victoria Street, London SW1H 0ET

Tel: 020-7215 6781/6772
Fax: 020-7215 6565
DTI switchboard: 020-7215 5000

Water or sewerage undertakings

9.5 In some circumstances, mergers of water or sewerage undertakings are subject to mandatory reference to the CC. The Act has modified the Water Industry Act 1991 so that the OFT must refer any merger involving two or more 'water enterprises' if the turnover of the target water enterprise exceeds £10 million or if the acquiring firm already owns water enterprises that each have turnover exceeding £10 million. (A 'water enterprise' is an enterprise carried on by a water or sewerage undertaking appointed under section 6 of the Water Industry Act 1991.) The OFT will consult the Director General of Water Services and the parties before making such a reference, taking account of whether, in the case of an anticipated merger, the arrangements are sufficiently far advanced to warrant reference or are sufficiently likely to proceed.

9.6 In reporting on the effects on the public interest of any merger referred under the Water Industry Act, the CC must have regard to whether the merger would prejudice the ability of the Director General of Water Services in carrying out his regulatory functions to make comparisons between different water enterprises. The CC must also have regard to whether or not there might be customer benefits which are substantially more important than the prejudice caused by the lack of comparators.

Regulated utilities

9.7 There are no special provisions under UK merger legislation for regulated utilities such as electricity, gas, telecommunications or rail. In principle, therefore, mergers in regulated industries are subject to the Act in the same way as any other merger. However, a merger in a regulated industry may well require the modification of an operating licence or give rise to other issues falling within the expertise of the relevant regulator. For this reason, the OFT and the sectoral regulators work closely together on mergers in regulated industries. In some cases, the regulator may issue a consultation document in respect of the merger, the responses to which will inform the views offered to the OFT by the

regulator. Neither the OFT, nor the Secretary of State (in public interest cases) will be bound by the regulator's views but they would pay close attention to them since the regulator may comment on matters that fall outside the OFT's areas of expertise.

10 PUBLIC INTEREST CASES

10.1 The Act provides that the Secretary of State may issue an intervention notice to the OFT in any merger case which raises issues of public interest. The Act currently defines only national security as a public interest criterion, although there is provision for the Secretary of State to identify additional public interest criteria. The Act requires the OFT to keep the Secretary of State informed of cases where public interest issues (as currently defined in the Act) arise in order to determine whether to intervene in the case.

10.2 The OFT must also keep the Secretary of State informed of any representations it receives about adding new public interest issues that the Secretary of State may wish to add to the list of issues in the Act. The Secretary of State may issue an intervention notice in relation to a merger which raises a new public interest issue which she proposes to define as a public interest criterion under the Act. The case will then be handled as if the criterion existed, although there are limits on concluding the case while the new criterion is being considered by Parliament.

10.3 Public interest cases will be considered with respect to both competition and public interest issues and the timetable will be extended (usually by ten working days) to allow time for these issues to be considered. When the OFT receives an intervention notice it has a duty to publicise this fact and to invite representations on the public interest issues from interested parties.

10.4 The OFT will perform its competition investigation in the usual way to determine whether or not it believes there is a relevant merger situation and, if so, whether or not it believes that the merger situation might substantially lessen competition. If the OFT believes that the merger might have this effect, it will further consider whether any of the exceptional grounds for not making a reference (described above) are satisfied in the case. The OFT will then report its findings on the competition issues – together with a summary of any representations received on the public interest issues – to the Secretary of State. The OFT will not usually make any recommendation on the public interest matter because comment on such issues lies outside our competition expertise.

10.5 The outcome of the case then depends on a decision of the Secretary of State.

- If the Secretary of State considers that public interest issues are material to the outcome of the case, she may clear the transaction (even if the OFT has advised its belief that the merger may be expected to substantially lessen competition), make a reference to the CC, or ask the

OFT to seek undertakings in lieu of a reference. In each case, the decision may take account of a combination of public interest and competition issues, or be based on public interest elements only. The Secretary of State will be required to publish reasons for public interest decisions.

- If the Secretary of State considers that public interest issues are not material to the outcome of the case, she will return the case to the OFT, which will make a decision consistent with its advice on competition issues. This may be a clearance, undertakings in lieu, or a reference – in each case on competition grounds.

Special merger situations

10.6 The Act also provides for a special category of merger cases which do not qualify for scrutiny under the general merger regime. These cases raise issues of national security because one or more of the parties to the merger is a relevant government contractor. The Act prescribes a special regime for such mergers. As for a public interest case, the Secretary of State can issue a notice to direct the OFT to investigate a merger without considering whether the merger would qualify for investigation under the share of supply or turnover jurisdictional tests. Obviously, if the merger does so qualify, the merger will be treated as a public interest case (see above). If the merger does not qualify for investigation under share of supply and turnover tests, the OFT will report to the Secretary of State on its conclusions as to why the case does not qualify for competition investigation under the Act, and will also provide a summary of any comments received on public interest issues in respect of that merger.

10.7 The Secretary of State will then decide the outcome of such cases, which may be reference, clearance, or undertakings in lieu of a reference, based solely on public interest issues. The Secretary of State may direct the OFT to negotiate the undertakings, and the usual procedures will be followed.

11 INTERACTION WITH EC MERGER CONTROL REGIME

11.1 Some mergers above a certain size fall outside the scope of the Act's jurisdiction. Instead, they are notifiable to the European Commission's Mergers Task Force (MTF) in Brussels under Council Regulation 4064/89 (as amended) (the EC Merger Regulation). Mergers fall under the jurisdiction of the MTF when they satisfy one of two alternative sets of jurisdictional thresholds:

- **either**
  the combined worldwide turnover of the merging parties exceeds five billion euros; each of two parties to the merger achieved turnover within the EU of more than 250 million euros; **and** neither of the two parties to the merger achieved more than two-thirds of their EU turnover in one and the same Member State

- **or**
  the combined worldwide turnover of the merging parties exceeds 2.5 billion euros; the combined turnover of the merging parties is 100 million euros in at least three EU Member States; in each of these three Member States, at least two parties to the merger each has a turnover of more than 25 million; each of two parties to the merger must achieve turnover within the EU of more than 100 million euros; **and** neither of those two parties to the merger achieved more than two-thirds of their EU turnover in one and the same Member State.

11.2 Where a merger satisfies one of these two sets of jurisdictional thresholds, the merger must be notified to the MTF. National merger control laws are expressly excluded from applying to mergers falling under the EC Merger Regulation (Article 21(1) and (2) ECMR).

11.3 The OFT fulfils a number of the functions of the UK's competent authority under the EC Merger Regulation. This includes liaison with the MTF on the assessment and disposal of cases notified to the MTF. It also includes deciding when to request a case back from Brussels under Article 9 of the EC Merger Regulation, and when to seek to refer a case to Brussels under Article 22.

11.4 Under Article 9, a Member State may request that a case be referred back from Brussels in either of two specific circumstances: (a) the merger threatens to create or strengthen a dominant position on a distinct market within a Member State; and (b) where the merger affects competition on a distinct local market.

11.5 A Member State or Member States may refer a case to Brussels for investigation under Article 22 where a merger that does not meet the thresholds for notification in Brussels (see paragraph 11.1 above) creates or strengthens a dominant position as a result of which effective competition would be significantly impeded in the territory of the Member State or States making the referral request. Accordingly, it is possible that certain mergers notified to the OFT under the Act may be referred to the MTF for consideration.

11.6 Notwithstanding the comments above regarding the exclusive jurisdiction of the European Commission for mergers that meet the thresholds, Article 21(3) ECMR does permit Member States to take separate action to protect certain legitimate interests, including public security and plurality of the media. This would enable the Secretary of State, for example, to ask the OFT to obtain public interest undertakings under the Act in respect of a merger caught by the ECMR.

11.7 The EC Merger Regulation is presently under review by the European Commission. The outcome of this review is not yet known, and it may be that this Part of the guidelines requires amendment to address future changes to the EC Merger Regulation.

12 FURTHER INFORMATION

12.1 Further information can be obtained from:

The Mergers Branch
Office of Fair Trading
Fleetbank House
2-6 Salisbury Square
London EC4Y 8JX
Tel: 020-7211 8915/8917/8918
Fax: 020-7211 8916
and from the OFT's website (www.oft.gov.uk).

12.2 Although these guidelines cover the points likely to be of immediate concern to companies and their advisers, the booklet makes no claim to be comprehensive. It cannot be seen as a substitute for the Act and the regulations and orders made under it. Anyone in any doubt about whether they may be affected by the legislation may wish to seek legal advice.