
Revision to *Mergers – substantive assessment guidance*

Exception to the duty to refer: markets of insufficient importance

OFT516b

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1 INTRODUCTION AND BACKGROUND

Following public consultation, the OFT has decided to publish revised guidance (the Guidance) in relation to the so-called 'markets of insufficient importance' exception to its duty to refer certain mergers under the Enterprise Act 2002 (the Act) (hereinafter 'the exclusion').

This guidance is currently contained in paragraphs 7.5 and 7.6 of the OFT's *Mergers – Substantive assessment guidance* (OFT 516, May 2003).¹ A proposed revision of the relevant text (the Draft) was published in June 2007² and stakeholders were invited to comment in relation to the Draft.

This document sets out the consideration the OFT has given to the principal issues arising from the responses to the consultation and changes made in finalising the Guidance as a result. It also sets out a summary of responses to the consultation. The revised Guidance is attached, paper copies of which will also be available on request from the OFT.

¹ www.offt.gov.uk/shared_offt/business_leaflets/enterprise_act/oft516.pdf

² www.offt.gov.uk/shared_offt/consultations/oft933con.pdf

2 COMMENTS ON THE GUIDANCE

The OFT believes that the revised Guidance will allow the markets of insufficient importance exclusion to be applied to a larger number of cases where the costs involved in a reference are disproportionate to the benefits.

The consultation exercise has also helped the OFT significantly clarify its approach and therefore provide better direction to stakeholders. Specific issues are covered in turn below.

Transparency

Some respondents suggested that the OFT provide reasoning in cases where it does not apply the exclusion below the relevant £10 million threshold. The OFT confirms it will do so, having always intended to provide reasoning in relation to all its decisions to apply or not to apply the markets of insufficient importance exclusion to mergers where the affected market(s) fall at or below the £10 million threshold.

Market size threshold

The Guidance introduces a significant increase of the threshold for a market to be considered of insufficient importance from £400,000 to £10 million. No respondent considered the increase to £10 million too high. On the contrary, some stakeholders were of the view that the threshold could be even higher (for example, £20 million or £100 million) taking into account factors such as the private costs involved in a reference to the Competition Commission (CC) or the turnover of the merging companies. The OFT was not persuaded that further raising the threshold above a multiple of 25 times its current figure would be appropriate at this stage, believing that this figure, while based on a qualitative judgment, is consistent with a balanced approach under cost/benefit principles.³ However, the OFT retains its proposal in the Draft to keep the relevant figure under review and adjust it periodically as appropriate.

³ This was discussed in detail in the consultation document, paragraphs 4.9-4.16.

The OFT accepted the comments that the Draft was not sufficiently clear in relation to the how the value of the affected market(s) will be calculated for the purposes of the application of the threshold. The amended Guidance makes the relevant calculation principles clearer for parties and their advisers to apply.

Application to certain cases within the threshold

The Guidance now makes clear that, subject to the caveats discussed below, the OFT will generally consider affected markets worth less than £10 million in aggregate to be of insufficient importance to justify reference.

The Draft introduced two categories of cases, however, in which the use of the *de minimis* exclusion was 'less likely' to be appropriate despite the market(s) falling within the relevant threshold size figure:

- (1) mergers in very highly concentrated markets where the prospect of entry is low and
- (2) mergers in markets where there is evidence of coordination between competitors.

A number of commentators expressed concern that the first category of cases was described too broadly and could embrace most cases in relation to which the OFT's duty to refer is triggered. In addition, some respondents felt that the language used in the Draft implied that the OFT would be using this caveat from the general markets of insufficient importance exclusion too often.

The OFT amended the text of the Guidance to clarify that the pivotal issue is whether the **impact of the merger is likely to be particularly significant**. Cases will not inevitably be referred if they fall within the two categories identified. Rather, the Guidance now explains that the OFT, taking into account all the circumstances, may apply the exclusion even within these categories if its overall assessment is that the total merger impact is likely to be limited. Conversely, the OFT will not use the exclusion if the consumer welfare impact is likely to be particularly significant.

In placing the predicted impact of a particular merger on the scale between limited and particularly significant, the OFT will pay close attention to the interaction of three key variables:

- (1) **the size of the market** – according to the principles for calculation outlined in the Guidance
- (2) **the magnitude of the competition lost by the merger** – or, in other words, the merger's likely short-run effect on price or non-price parameters of competition such as innovation, service quality, and product range, and
- (3) **the durability of the merger's impact** – which will be governed by factors such as entry, expansion, buyer power and market transformation.

Therefore, all else equal, the smaller the market, the greater the likelihood the exclusion will be used. The same is true of the magnitude of lost competition. Finally, and again all else equal, the more obviously finite and circumscribed the period of any merger effects, the greater the likelihood the OFT will consider that the merger has a limited impact. This could, for example, be because:

- the OFT is confident that while effective new entry will ultimately occur, short term entry is not sufficiently certain, or likely to be of sufficient scale and scope, to prevent a realistic prospect of a substantial lessening of competition, or
- because market changes, such as technological developments or other transformations, suggest that any merger effects will over time be removed or have dissipated.

These examples are indicative rather than exhaustive.

The OFT believes that the final wording of the Guidance provides greater clarity on cases that would be caught by the duty to refer but may nonetheless benefit from the *de minimis* exclusion.

In response to comments in relation to the second category of cases relating to **evidence of coordination**, the OFT has made explicit in the Guidance that a merger may only fall under this category where the merger itself makes coordination worse, that is, more effective, widespread or durable.

In other words, because the Act's test is one of causation, merger control is not being used as an indirect punishment for anticompetitive conduct in the market in circumstances where the merger itself does not provide cause for concern. For these cases, the OFT will also take into account the merger's total impact on consumer welfare, and may apply the *de minimis* exclusion if its effect is likely to be limited. Further guidance will be provided by way of informal advice and decisional practice when particular issues arise, rather than providing an up-front catalogue of all conceivable scenarios in the Guidance itself.

In keeping with the previous guidance, the OFT has chosen to retain the principle that it may decline to apply the markets of insufficient importance exclusion if a reference would have important precedent value, for example, because the case raises novel issues, or if vulnerable consumers are likely to suffer a substantial proportion of the detriment caused by the merger. The OFT accepted suggestions to amend the wording of the Guidance to clarify the narrow range of circumstances in which a merger will fall under either of these categories.

3 SUMMARY OF RESPONSES

All respondents welcomed the OFT's initiative. The OFT received comments from 11 law firms, four trade associations, three companies, and 16 letters from individuals forwarding essentially the same text.

The main issues arising from the responses were:

- appropriateness of the revised threshold for markets of insufficient importance
- cases where the use of the exclusion is less likely (paragraphs 7.7 and 7.8 of the consultation document)
- application of the guidance in practice.

Revised threshold

Most respondents considered that the £10 million threshold – above which a market is likely to be considered of sufficient importance to justify a reference to the CC – is appropriate.

However, some respondents submitted that private costs should also be taken into account when setting the market size threshold, and two of them suggested a figure of £20 million based on this principle. Following a similar logic, other respondents suggested a much higher threshold (£100 million market size and/or turnover of any of the parties of at least £10 million) based on various assumptions to calculate how long it would take for the parties to a referred merger to recoup the costs of reference.

Furthermore, some respondents suggested the adoption of a 'safe harbour' threshold, to the effect that the OFT would be unlikely to refer a merger in market sizes within the safe harbour brackets.

Finally, some respondents asked for clarification in relation to how the value of the affected market will be calculated, in particular in relation to mergers affecting a number of local markets, and to vertical and conglomerate mergers.

Cases where use of the exclusion is less likely

- **Very high concentration and low entry prospects**

A number of respondents considered this caveat too far reaching and noted that it would apply to the vast majority of mergers that trigger a duty to refer.

Two firms suggested that a more flexible approach to barriers to entry should be taken in the application of the *de minimis* exclusion in comparison with the assessment of whether the merger may be expected to result in a substantial lessening of competition. This would create a 'gap' between the two analyses and allow a larger number of cases to be cleared under the markets of insufficient importance exclusion.

- **Evidence of coordination**

Some respondents questioned the rationale behind this caveat, arguing essentially that closer merger scrutiny is not an effective way to deter cartel activity, and that the Competition Act 1998 (or Article 81 of the EU Treaty) is the appropriate instrument to deal with cartels.

Respondents also required clarification on the practical application of this caveat, in particular: to which types of agreement and to which markets it will apply; whether the merging parties must be involved in the coordination; whether there are any limit of time lag between the end of the coordination and the application of the caveat; and whether the merger must have an impact on coordination.

- **Precedent value**

A few respondents considered that this caveat is unfair on the companies involved in the first merger in the industry. It was said that this is inconsistent with the cost/benefit approach of the Draft and that it makes self-assessment more difficult.

- **Vulnerable consumers**

A number of respondents queried the economic justification for this caveat. While others agreed with it, some requested clarification on the concept of vulnerable customers. It was also said that this caveat could in practice rule out the application of the markets of insufficient importance exclusion to many consumer-facing markets.

Practical application

Most respondents welcomed the availability of informal advice to deal with *de minimis* issues.

Some respondents suggested that the OFT should give reasons when it decides not to use the *de minimis* exclusion to cases where the annual value of the affected market in the UK is less than £10 million. In addition, some suggestions were made in relation to the language used in the draft guidance to clarify the actual likelihood of the *de minimis* exclusion being applied and facilitate self-assessment.

4 THE REVISED GUIDANCE

Markets of insufficient importance

Purpose of the exception

- 7.5** The OFT may exceptionally decide not to refer such a merger to the CC if it believes that the market(s) to which the duty to refer applies are not of sufficient importance to justify a reference. By precluding a CC reference, use of this provision has the same effect as an exemption that clears the merger unconditionally. Its purpose is to avoid references being made where the costs involved would be disproportionate.⁴

The basis of the OFT's approach

- 7.6** Before using this discretion the OFT will exercise its judgment in considering each case on its individual facts. A key issue for the OFT in this regard is the expected impact of the transaction on consumer welfare, considering in particular market size, the magnitude of competition lost by the merger, and the likely duration of that loss, as well as other relevant market features. The OFT is most likely to exercise its discretion not to refer where the relevant market features (which will overlap with those relevant in the assessment of the substantial lessening of competition) indicate that the merger's total impact is likely to be limited. The OFT is generally likely to consider the affected market(s) to be of sufficient importance to justify a reference where their annual value in the UK, in aggregate, is more than £10 million.

⁴ The lower bound for the assessment of relevant costs will be the cost to the public purse of a CC reference. At the time of writing, the OFT understands that this falls within a typical range of £300,000 to £750,000.

Calculation of market size

For these purposes

- Only markets in relation to which the OFT concludes there is a realistic prospect of a substantial lessening of competition qualify as 'affected' markets;
- Market size is the sum of all suppliers' annual turnover in the UK in that affected market;
- If the geographic scope of any affected market is wider than the UK, turnover generated outside the UK will not be taken into account;
- Where a merger results in several affected markets, the relevant figure will be the aggregate size of all such markets;
- Rapid market growth or decline will be relevant to calculating future market size and importance.

Below the £10 million market size threshold, the OFT would generally consider the market to be of insufficient importance to justify a reference, subject to the caveats listed below.

Cases where the merger impact is likely to be particularly significant

7.7 Where the total impact of the merger in terms of consumer harm is likely to be particularly significant, the OFT will not consider the market to be of insufficient importance to justify a reference, even in cases below the £10 million market size threshold. The OFT may decline to make use of the exception below the £10 million threshold where there is:

- **Very high market concentration and low entry prospects.** If there is evidence to suggest that a market is very highly concentrated and has substantial and durable barriers to entry and/or expansion, it will potentially be vulnerable to substantial merger effects that are likely to persist because, at best, any self-correction will occur no earlier than the medium term. For example, in such a market, where the OFT considers each merging party to be the *only* significant competitor to the other (a '2 to 1' merger) or one of only two (a '3 to 2' merger), the merger would typically lead to large price increases and/or quality or

innovation cutbacks, which will endure into the medium term and potentially beyond; and/or

- **Evidence of coordination.** If there is evidence of coordination between competitors (such as hard-core breaches of Chapter I of the Competition Act 1998) in one or more of the markets in question, and the merger may increase the impact of any such coordination -- for example, by preventing or slowing down the emergence of competition that disrupts the coordination, or otherwise facilitating more durable, effective or widespread coordination -- the OFT is likely to regard the market as of sufficient importance to justify a reference.

In all cases, the OFT's focus will be on the potential scope of the merger's total impact on consumer welfare. Thus, even in cases falling within the above categories, the OFT may apply the exception if its overall assessment is that the total merger impact is likely to be limited, for example because the market is very small, or the magnitude or duration of the loss of competition is unusually limited, or another appropriate combination of the relevant variables suggest a limited impact.

7.8 Use of the exception may also be less appropriate where:

- a reference would have important precedent value, for example, because the case raises novel issues, so that an in-depth CC inquiry would provide guidance for the industry concerned; and/or
- a substantial proportion of the likely detriment is suffered by vulnerable consumers.

Use of informal advice

7.9 If merging parties and their advisers are in doubt as to the exercise of this discretion, the OFT (via the Mergers Group) will offer informal advice, subject

to the caveats generally applicable to such guidance.⁵ Seeking proper advice at the transaction planning stage, supplemented where necessary by informal advice from the OFT, will be preferable to proceeding with a merger on misplaced expectations as to the OFT's likely decision. This is especially true with respect to this exception to the duty to refer, as the proposed transaction at issue will often be small, and the cost of a CC inquiry to the parties, relative to the size of the transaction, will be substantial.

Periodic adjustments

7.10 The OFT may periodically announce an adjustment to the relevant market size guideline figure to take into account its experience under the Act, as well as factors relevant to proportionality, such as changes to the average cost of relevant CC inquiries and inflation.

⁵ See Interim arrangements for informal advice and pre-notification contacts, April 2006, available on the Mergers section of the OFT website at www.offt.gov.uk/advice_and_resources/resource_base/Mergers_home/publications