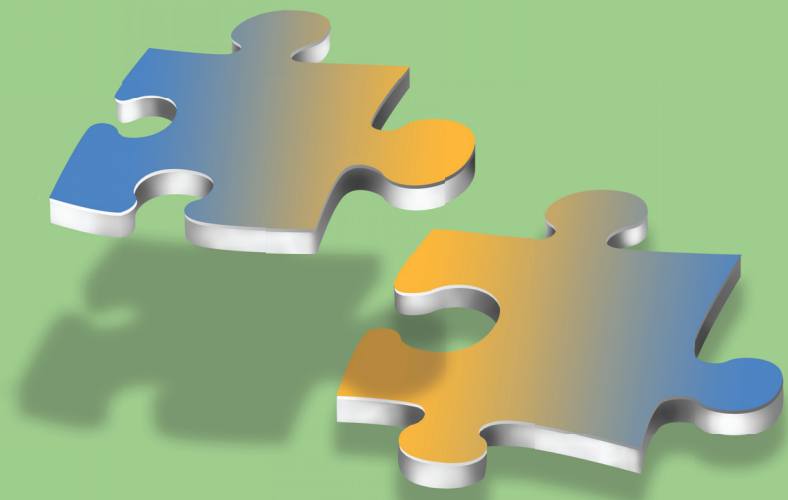


Merger Assessment Guidelines



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Part 1

Introduction

■ Overview

1.1 This publication (the *Merger Assessment Guidelines*) forms part of the advice and information published by the Office of Fair Trading (OFT) and the Competition Commission (CC) under sections 106(1) and (3) respectively of the Enterprise Act 2002.¹ It is the first joint guidance document and supersedes the following OFT and CC guidelines:

- OFT publications: *Mergers—substantive assessment guidance (OFT516)*, *Guidance note revising Mergers—substantive assessment guidance (OFT516a)* and *Restatement of OFT’s position regarding acquisitions of ‘failing firms’ (OFT1047)*;² and
- CC publication: *Merger References: Competition Commission Guidelines, CC2*.

1.2 The publication explains the approach of the OFT when considering whether or not to refer a merger to the CC for further investigation and the approach of the CC when exploring more extensively the statutory questions posed in merger references. It highlights the differences of emphasis, as well as the commonalities, between the approaches of the OFT and the CC (‘the Authorities’). The new guidelines comprise seven parts:

- Part 1 provides some explanatory notes and outlines the UK merger regime.
- Part 2 sets out the overarching questions the OFT and the CC must consider in conducting reviews of mergers.
- Part 3 explains what is meant by a ‘relevant merger situation’.
- Part 4 explains the Authorities’ approach to the concept of a ‘substantial lessening of competition’ (SLC) and outlines the notions of ‘theories of harm’ and the ‘counterfactual’.

1 <http://www.opsi.gov.uk/acts/acts2002>.

2 As at September 2010, Chapters 7 (exceptions to the duty to refer) and 8 (undertakings in lieu of reference) of the OFT publications *Mergers—substantive assessment guidance (OFT516)* (revised by *Mergers—substantive assessment guidance—Exception to the duty to refer: markets of insufficient importance (OFT 516b)*) continue to apply prior to publication of *Mergers—exceptions to the duty to refer and undertakings in lieu of reference (OFT1122)*.

- Part 5 describes the analytical approach and methodologies applied by the Authorities in considering the SLC test.
 - Part 6 provides guidance on public interest cases.
 - Part 7 lists additional guidance relevant to the UK merger control regime.
- 1.3 Separate guidance relevant to mergers is published by the OFT and the CC from time to time. Such guidance available or under preparation at the time of publishing these guidelines (September 2010) includes publications on procedure, jurisdiction, the exceptions to the duty to refer mergers and, interim measures and remedies (see Part 7).

■ **Status of the *Merger Assessment Guidelines***

- 1.4 The *Merger Assessment Guidelines* apply with effect from the date of publication on the websites of the OFT or the CC.
- 1.5 In carrying out their functions, the OFT and the CC will have regard to these guidelines. The language in them is more definitive about some issues than about others, indicating that those areas of practice are more settled. However, merger assessment is inevitably case specific. It must take account of the particular transaction and the markets being analysed. The methodologies of merger analysis cannot be applied in a rigid and mechanistic way. The Authorities will therefore consider each merger with due regard to the particular circumstances of the case, including the information available and the time constraints applicable to the case,³ and will apply these guidelines flexibly, departing from them where they consider it appropriate to do so. Past case references are included for illustrative purposes only and do not constrain the approach of the Authorities.
- 1.6 These guidelines reflect the views of the OFT and the CC at the time of publication. Markets, economic theory, legal thinking and best practice evolve; the Authorities may revise the guidelines from time to time to reflect developments and may publish new or supplemental guidance. The latest version of the *Merger Assessment Guidelines* is always that appearing on the OFT and CC websites.

■ **Note on terminology**

- 1.7 Throughout this publication:
- the term ‘the Authorities’ is used when the guidelines apply to both the OFT and the CC; where that is not the case, the relevant body is specifically identified;
 - all references to statute, unless otherwise stated, relate to the Enterprise Act 2002—referred to throughout as ‘the Act’ and all references to ‘section(s)’, unless otherwise specified, relate to the Act;

.....
³ For further information about the statutory deadlines applying in Phase 1 and Phase 2, see OFT *Mergers—Jurisdictional and Procedural Guidance (OFT527)* and CC *General Advice and Information, CC4*, respectively.

- situations leading to an SLC are generally described in the future tense, regardless of whether the merger involved is completed or anticipated;
- the term ‘products’ is used to apply to goods and/or services;
- the term ‘merger’ covers all types of arrangements that may give rise to two or more enterprises ceasing to be distinct; and
- the term ‘price’ is used as shorthand for all aspects of competition unless otherwise specified.

■ **The UK merger regime**

- 1.8 The assessment of mergers in the UK is conducted as a two-phase process, giving distinct but interrelated roles to the OFT, the CC and, exceptionally, the Secretary of State for Business, Innovation and Skills. Both anticipated and completed mergers are covered by the Act.
- 1.9 At Phase 1, the OFT obtains and reviews information relating to merger situations.⁴ UK merger control law does not require that a qualifying merger (ie a relevant merger situation⁵) be notified to the OFT. However, firms can seek legal certainty by informing the OFT about a prospective merger in advance so as to obtain clearance. The OFT has a duty to refer to the CC for further investigation any relevant merger situation where it believes that it is or may be the case that the merger has resulted or may be expected to result in an SLC.⁶ A decision by the OFT not to refer may be made unconditionally or be made subject to the provision of undertakings in lieu of reference.
- 1.10 By contrast, under the Water Industry Act 1991,⁷ the OFT has a duty to refer water mergers between two or more water enterprises if their turnovers are above defined thresholds (see *Water Merger References: Competition Commission Guidelines, CC9*).
- 1.11 The Secretary of State has a role in certain merger cases where there is a specified public interest consideration and the Secretary of State has served an intervention notice. In these circumstances, the OFT must advise the Secretary of State on jurisdiction and competition issues, if any, of exceptions to the duty to refer and the appropriateness of addressing the competition concerns through undertakings.⁸ In media cases Ofcom, the regulator and competition authority for the UK communication industries, must also provide a report. The Secretary of State may refer public interest and special public interest cases to the CC. (The different types of public interest cases are described in Part 6.)
- 1.12 At Phase 2, the CC investigates mergers that are referred to it, either by the OFT or, in public interest or special public interest cases, by the Secretary of State.

.....

4 Section 5: the OFT is responsible for obtaining, compiling and keeping under review information about matters related to the carrying out of its functions, including merger review.

5 See Part 3.

6 Sections 22 and 33. The duty is subject to discretionary and mandatory exceptions (see paragraphs 2.8 to 2.10).

7 Section 32 of the Water Industry Act 1991.

8 For further information on the OFT’s role, see *OFT Mergers—jurisdictional and procedural guidance (OFT527)*.

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 a relevant statutory power. The CC determines the outcome of merger cases referred to it by the OFT. In the event that it finds that the merger will lead to an SLC, the CC decides upon remedies and has powers to implement them. The possible outcomes of public interest cases referred to the CC are described in Part 6.

■ The European dimension

- 1.13 Mergers that have a ‘Community dimension’ under the EC Merger Regulation (ECMR) (ie mergers above certain thresholds) fall outside the scope of the Act’s jurisdiction.⁹ Instead they must be notified in advance to the European Commission in Brussels.
- 1.14 Such mergers may be considered under the Act in certain circumstances. The European Commission may decide to transfer the merger, in whole or part, to the UK at the request of the merger firms¹⁰ or of the OFT.¹¹ A merger falling under the ECMR may also be considered by the Authorities at the initiative of the Secretary of State so as to protect certain legitimate interests¹² (see Part 6).
- 1.15 In some circumstances, mergers that do not meet the thresholds for notification to the European Commission under the ECMR may be transferred to the European Commission at the request of the merger firms¹³ or the OFT.¹⁴ Accordingly, it is possible that a merger notified to the OFT under the Act could be referred to the European Commission. Further details on the relationship between the UK and European merger control systems are set out in the OFT’s *Mergers—jurisdictional and procedural guidance (OFT527)* (Chapter 11).
- 1.16 Whereas the UK merger regime applies an SLC test, the European Commission, in its review under the ECMR, considers whether the merger would significantly impede effective competition, in particular as a result of the creation or strengthening of a dominant position.¹⁵ Nonetheless, the underlying economic approach to assessment carried out by the Authorities is generally similar to that carried out by the European Commission.
- 1.17 However, the structural difference between the regimes has implications for the substantive assessment of mergers. For example, the compulsory pre-notification requirement of the EU merger control regime allows the European Commission to assess the transaction in the light of the competitive situation that prevailed at the time of the notification. In the context of parallel transactions in the same market between different parties this effectively allows a ‘first past the post’ system based on the date of notification. By contrast, the counterfactual

9 Article 21(1), (2) and (3) of Council Regulation (EEC) No 139/2004/EC of 20 January 2004. The ECMR remains the official title of the regulation and its terminology is used throughout this publication.

10 Article 4(4) of the ECMR.

11 Article 9 of the ECMR.

12 Article 346, *Treaty on the Functioning of the European Union* (TFEU) and Article 21(4) of the ECMR and section 67 of the Act.

13 Article 4(5) of the ECMR.

14 Article 22 of the ECMR.

15 Article 2 of the ECMR.

used by the Authorities cannot be so standardized (see Part 4, section 4.3, for a description of the Authorities' approach).

- 1.18 The OFT fulfils several functions as the UK's competent authority under the ECMR. This includes liaison with the European Commission on the assessment and determination of cases notified to the European Commission. The OFT's role, the jurisdictional aspects of the ECMR and the role of the Secretary of State are more fully described in the OFT publication *Mergers—jurisdictional and procedural guidance (OFT527)*.

Part 2

Merger review by the OFT and the CC

Part 2 of the guidelines deals with the overarching questions the OFT and CC must address. It describes both the similarities and the differences between the ways in which the OFT, at Phase 1, and the CC, at Phase 2, approach these questions.

- 2.1 In assessing a merger, both Authorities must consider whether:
- (a) a relevant merger situation has been created (or, for anticipated mergers, will be created); and, if so,
 - (b) whether or not this situation will lead to an SLC.
- 2.2 Under the UK's two-phase merger control regime, the OFT and the CC are required to apply different thresholds when answering the statutory questions in the Act. The OFT applies a 'realistic prospect' threshold¹⁶ whereas the CC applies a 'balance of probabilities' threshold (see paragraph 2.6, 2.7 and 2.12). Therefore, while the approach described in these guidelines will generally be followed by both Authorities, the difference in evidential threshold will sometimes require a difference in the emphasis attached to certain aspects of the analysis (see paragraph 5.1.3). Examples of where this will be the case are highlighted throughout these guidelines.
- 2.3 When answering the statutory questions it is not necessary for the Authorities to apply the SLC test separately at each step of the analytical process. The standard of proof applies to the Authorities' overall conclusions on the statutory questions which they have to decide.¹⁷

■ Phase 1

■ *OFT's duty to refer mergers to the CC*

- 2.4 The OFT has a duty to refer completed and anticipated mergers to the CC for investigation if it believes that it is or may be the case that:¹⁸
-

¹⁶ The 'realistic prospect' formulation is shorthand for more complex statutory language. The Court of Appeal clarified the meaning of 'is or may be the case that ... may be expected to result' used in sections 22 and 33 in its judgment dated 19 February 2004 in *IBA Health Limited v OFT [2004] EWCA Civ 142*.

¹⁷ Clarity about the application of the threshold applicable to the CC when answering the SLC question was provided by the Court of Appeal in *BSkyB and Virgin Media v Competition Commission and BERR [2010] EWCA Civ 2*, paragraph 69; <http://www.bailii.org/ew/cases/EWCA/Civ/2010/2.html>.

¹⁸ Sections 22 and 33.

- a relevant merger situation has been created, or arrangements are in progress or contemplation which, if carried into effect, will result in the creation of a relevant merger situation; and
 - the creation of that situation has resulted, or may be expected to result, in an SLC within a market or markets in the UK for goods or services. The OFT is not required to consider this question if it does not believe that there is or may be a relevant merger situation.
- 2.5 In considering whether to refer a merger to the CC, the OFT must form a reasonable belief, objectively justified by relevant facts, as to whether or not it is or may be the case that the merger has resulted, or may be expected to result, in an SLC.
- 2.6 The OFT must make a reference to the CC when it believes that the merger is more likely than not to result in an SLC. The Act also contemplates reference at lower ranges of probability. If the OFT believes that the relevant likelihood is greater than fanciful, but below 50 per cent, it has a wide margin of appreciation in exercising its judgement. In such cases, it has a duty to refer when it believes there to be a realistic prospect that the merger will result in an SLC.
- 2.7 The realistic prospect threshold is intentionally a lower and more cautious threshold for an SLC finding than that applied by the CC after more extensive investigation (see paragraph 1.2). The OFT’s judgement on whether there is a realistic prospect of an SLC will take due account of the extent of the evidence available to it at the time of its decision.
- 2.8 The OFT’s duty to refer is also subject to the application of discretionary exceptions.¹⁹ The OFT may decide not to refer if it believes that:
- (a) the market(s) concerned is (are) not of sufficient importance to justify the making of the reference (the ‘de minimis’ exception);
 - (b) any relevant customer benefits outweigh the SLC and any adverse effects of the SLC; and
 - (c) in the case of an anticipated merger, the arrangements concerned are not sufficiently far advanced, or are not sufficiently likely to proceed, to justify a reference.
- 2.9 By precluding a CC reference, application of the first two of the above three provisions has the same effect as an unconditional clearance of the merger.
- 2.10 In addition, the OFT may not make a reference in certain other circumstances. These include when the OFT is considering whether to accept undertakings in lieu of making a reference.²⁰ Further information about the exceptions to the duty to refer will be set out in the OFT publication *Mergers—exceptions to the duty to refer and undertakings in lieu of reference (OFT1122)*.²¹

.....

19 Sections 22(2) and 33(2).
 20 Sections 22(3)(b) and 33(3)(b).
 21 To be published.

■ Phase 2

■ Questions for the CC

2.11 The CC has first to decide two questions:²²

- whether a relevant merger situation has been created (or for anticipated mergers, whether arrangements are in progress or in contemplation which, if carried into effect, will result in the creation of a relevant merger situation); and if so
- whether the creation of that situation has resulted, or may be expected to result, in an SLC within any market or markets in the UK for goods or services.

The CC is not required to consider the second question if it decides that no relevant merger situation exists or will do so.

2.12 In answering the two questions the CC will apply a ‘balance of probabilities’ threshold to its analysis, ie it addresses the question: is it more likely than not that an SLC will result?²³ It must therefore form an expectation which has a higher level of probability than that required of the OFT (see paragraphs 2.6 and 2.7), calling for a more extensive investigation than that carried out at Phase 1. If the CC decides that there is an anti-competitive outcome²⁴—that is, it has answered both questions in the affirmative—it must then consider possible remedies.

2.13 In its consideration of remedies, the CC must decide three questions:²⁵

- (a) whether action should be taken by the CC for the purpose of remedying, mitigating or preventing the SLC concerned or any adverse effect which has resulted from, or may be expected to result from, the SLC;
- (b) whether the CC should recommend the taking of action by others for the purpose of remedying, mitigating or preventing the SLC concerned or any adverse effect which has resulted from, or may be expected to result from, the SLC; and
- (c) in either case, if action should be taken, what action should be taken and what is to be remedied, mitigated or prevented.

Further information on the CC’s approach when deciding the remedy questions is set out in *Merger Remedies: Competition Commission Guidelines, CC8*.

.....
 22 Section 35(1) for completed mergers and section 36(1) for anticipated mergers.

23 The Court of Appeal has endorsed the approach of expressing an expectation as a more than 50 per cent chance—*IBA Health Ltd v OFT* [2004] EWCA Civ 142, paragraph 46.

24 Defined in section 35(2).

25 Sections 35(3) and 36(2).

Part 3

The ‘relevant merger’ situation

Part 3 of the guidelines deals with the first question each Authority has to consider: whether or not a ‘relevant merger’ situation has been, or will be, created.

■ Section 3.1: Introduction

3.1.1 The Act applies to a ‘relevant merger’ situation, ie a merger that meets one of the jurisdictional thresholds, and covers several kinds of transactions and arrangements. A company that buys or proposes to buy a majority shareholding in another company is the most obvious example. However, acquisitions of lesser shareholdings may also give rise to a relevant merger situation, as might the transfer or pooling of assets or the creation of a joint venture. In this Part of the guidelines, the criteria for determining whether there is a relevant merger situation are set out and guidance is provided on the following:

- (a) the meaning of ‘enterprises ceasing to be distinct’;
- (b) the turnover test;
- (c) the share of supply test; and
- (d) the time period for referring mergers.

3.1.2 A variety of issues relating to whether a relevant merger situation has arisen has been considered by the OFT. The OFT has therefore issued its own guidance providing further detail on what it will consider to be a relevant merger situation: the OFT’s *Mergers—jurisdictional and procedural guidance (OFT527)* (Chapter 3).

■ *Criteria for a relevant merger situation*

3.1.3 A merger must meet all three of the following criteria to constitute a relevant merger situation for the purposes of the Act:

- two or more enterprises must cease to be distinct, or there must be arrangements in progress or in contemplation which, if carried into effect, will lead to enterprises ceasing to be distinct; and

- either the value of UK turnover of the enterprise which is being acquired exceeds £70 million (known as ‘the turnover test’—see paragraphs 3.3.1 and 3.3.2);
 - or the enterprises which cease to be distinct supply or acquire goods or services of any description and after the merger together supply or acquire at least 25 per cent of all those particular goods or services supplied in the UK or in a substantial part of it (see paragraphs 3.3.6 to 3.3.8). The merger must result in an increment to the share of supply or consumption. In practice, therefore, the share of supply test can only be met where the enterprises concerned supply or acquire goods or services of a similar kind (known as ‘the share of supply test’—see paragraphs 3.3.3 to 3.3.5); and
- either the merger must not yet have taken place (see paragraph 3.3.9);
 - or (subject to certain exceptions) the merger must have taken place not more than four months before the reference is made (see paragraph 3.3.9 and 3.3.10).

3.1.4 It is clear from these criteria that at least one of the enterprises must be active within the UK. This must be the case where the turnover test is met, because the target generates turnover from sales to UK customers. For the share of supply test, both of the enterprises ceasing to be distinct must be active in supplying or acquiring goods or services within the UK or a substantial part of the UK. These principles apply equally to non-UK companies that sell to (or acquire from) UK customers or suppliers.

■ Section 3.2: Enterprises ceasing to be distinct

3.2.1 Two enterprises will ‘cease to be distinct’ if they are brought under common ownership or control.

■ ‘Enterprises’

3.2.2 The term ‘enterprise’ is defined in section 129 as the activities, or part of the activities, of a business. The enterprise in question need not therefore be a separate legal entity. The definition states that the activities in question should be carried out for ‘gain or reward’. However, there is no requirement that the transferred activities should be profitable, or generate a dividend for shareholders, and the definition may include transferred activities conducted on a not-for-profit basis.

3.2.3 In making a judgement as to whether or not the activities of a business, or part of a business, constitute an enterprise under the Act, the Authorities will have regard to the substance of the arrangement under consideration, rather than merely its legal form.

3.2.4 An enterprise may comprise any number of components, most commonly including the assets and records needed to carry on the business, together with the benefit of existing contracts and/or goodwill. In some cases, the transfer of

physical assets alone may be sufficient to constitute an enterprise, for example where the facilities or site transferred enable a particular business activity to be continued. Intangible assets such as intellectual property rights are unlikely, on their own, to constitute an enterprise unless it is possible to identify turnover directly related to the transferred intangible assets that will also transfer to the buyer. The business acquired may no longer be trading but this does not in itself prevent the business from being an enterprise for the purposes of the Act.

■ **Control**

3.2.5 'Control' is not limited to the acquisition of outright voting control but includes situations falling short of outright control. Section 26 distinguishes three levels of interest referred to as control (in ascending order):

- Company A, the acquirer, may acquire the ability materially to influence the policy of Company B, the target (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).

3.2.6 Section 26(3) provides the Authorities with a discretion to treat material influence and de facto control as equivalent to legal control.²⁶

3.2.7 The Act also contains provisions to deal with situations in which a company acquires control by stages or where 'associated persons' might act together to gain control.

'Material influence'

3.2.8 The ability to exercise 'material influence' is the lowest level of control that may give rise to a relevant merger situation. In assessing material influence in the context of the Act, the Authorities will conduct a case-by-case analysis, focusing on the overall relationship between the acquirer and the target and on the acquirer's ability materially to influence policy relevant to the behaviour of the target entity in the marketplace. The policy of the target includes its strategic direction and its ability to define and achieve its commercial objectives.

3.2.9 The acquirer's ability to influence the target's policy can arise through the exercise of votes at shareholders' meetings, together with any additional supporting factors that might suggest that the acquiring party exercises an influence disproportionate to its shareholding. Material influence may also arise as a result of the ability to influence the board of the target and/or through other arrangements.²⁷

26 See Competition Appeal Tribunal (CAT) Judgment in *BSkyB v. the CC and Secretary of State, and Virgin Media v the CC and Secretary of State* (September 2008), paragraph 104; http://www.catribunal.org.uk/files/1.Judg_revised_BSkyB_1095_Virgin_Inc_1096_290908.pdf.

27 See *BSkyB/ITV*, CC, December 2007.

3.2.10 In considering whether material influence may be present by virtue of a shareholding in a particular case, the Authorities will consider not only the ownership of the shareholding but also whether, as a matter of practice, the acquiring party is able to exert influence. Factors that may be relevant to an assessment of a particular shareholding include:

- the distribution and holders of the remaining shares, in particular whether the acquiring entity's shareholding makes it the largest shareholder;
- patterns of attendance and voting at recent shareholders' meetings based on recent shareholder returns, and in particular whether voter attendance is such that the shareholding under consideration would be able in practice to block special resolutions;
- the existence of any special voting or veto rights attached to the shareholding under consideration;
- the status and expertise of the acquirer and its corresponding influence with other shareholders; and
- any other special provisions in the constitution of the company conferring an ability materially to influence policy.

3.2.11 In addition to the ability materially to influence policy through the voting of shares, the Authorities' determination may also turn on whether the acquirer is able materially to influence the policy of the target entity through board representation. Indeed, it is possible that board representation alone could, in certain circumstances, confer material influence.

3.2.12 The Authorities may also consider whether any other factors, such as agreements with the company, enable the acquirer materially to influence policy. These might include the provision of consultancy services to the target or might, in certain circumstances, include agreements between firms that one will cease production and source all its requirements from the other. Financial arrangements may in certain circumstances confer material influence where the conditions are such that one party becomes so dependent on the other that the latter gains material influence over the company's commercial policy.

'De facto control'

3.2.13 It is possible that merger arrangements give rise to a position of 'de facto' control when an acquirer becomes clearly the controller of a company, notwithstanding that it holds a 50 per cent voting stake or less in the target company (ie it does not have a controlling interest). This is likely to include situations where the acquirer has control over more than half of the votes actually cast at a shareholders' meeting. It might also involve situations where an investor's industry expertise leads to its advice being followed to a greater extent than its shareholding would seem to warrant (although this factor could equally be relevant to a finding of material influence).

A ‘controlling interest’

3.2.14 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 described above) of two or more major shareholders at the same time—in a joint venture, for instance. Thus it is possible for a minority shareholder to have material influence over a company’s policy even though someone else owns a controlling interest.

Acquiring control by stages

3.2.15 Under section 26(4), should the circumstance (eg a shareholding or a level of board representation) 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 a new relevant merger situation. The same applies to a move from de facto control to a controlling interest.

3.2.16 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.

3.2.17 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, section 29 allows the transactions to be considered as having occurred or occurring simultaneously on the date of the last transaction and thus to be treated as a single reference. In giving effect to this provision, the Authorities may take into account transactions in contemplation.

‘Associated persons’

3.2.18 For the purposes of considering whether an enterprise has ceased to be distinct, section 127 requires the Authorities to consider whether several persons acquiring an enterprise are ‘associated persons’ and thus should be viewed as acting together.

3.2.19 This situation will most commonly arise where the acquiring persons are related or have an agreement to act jointly to make an acquisition, although the Act does not require that each of the acquiring parties should individually have control over the acquired entity for them all to be regarded as being associated persons.

■ **Section 3.3: The turnover test, the share of supply test and the time period**

■ *‘Turnover test’*

3.3.1 The ‘turnover test’ is satisfied where the annual value of the UK turnover of the enterprise being acquired exceeds £70 million.

3.3.2 In most situations, the turnover test is applied to the turnover of the acquired enterprise that was generated by the sale of goods or services to customers within the UK in the business year preceding the date of completion of the merger or, if the merger has not yet taken place, the date of the reference to the CC.²⁸

■ **'Share of supply test'**

3.3.3 Under section 23, the 'share of supply test' is satisfied if the merger enterprises:

- supply or acquire goods or services of a particular description; and
- will after the merger collectively 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, provided that the merger results in an increment to that share.

3.3.4 The increase in the share of supply must result from the enterprises ceasing to be distinct. In the case of an acquisition, the share of supply is based on the activities of the acquirer and the target company. In joint venture situations, the share of supply is calculated by reference to the activities of the joint venture, although it will include shares of the joint venture parents where they continue to undertake the same activities as the joint venture.

3.3.5 The Act expressly allows the Authorities a 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 is different from a market share (paragraph 5.3.4), and goods and services to which the share of supply test is applied need not amount to the market defined for the economic analysis. In addition, the Authorities may have regard to any reasonable description of a set of goods or services to determine whether the share of supply test is met—the value, cost, price, quantity, capacity, number of workers employed or any other criterion may be used to determine whether the 25 per cent threshold is reached.

Substantial part of the UK

3.3.6 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 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.²⁹ The Authorities will take into account such factors as 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.

28 See Section 28 and SI 2005/1370 as amended by SI 2005/3558.

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

3.3.7 For the application of the share of supply test, there is no need for the substantial part of the UK to constitute an undivided geographic area.³⁰

Supply of goods or services in the UK

3.3.8 The share of supply test requires that the merger would result in the creation or enhancement of at least a 25 per cent share of supply or acquisition of goods or services either in the UK or in a substantial part of the UK. Services or goods are generally deemed to be supplied in the UK where they are provided to customers who are located in the UK.³¹

■ ***Time period for investigating mergers***

3.3.9 To meet the criteria for a relevant merger situation, the merger must either not yet have taken place or have taken place not more than four months before the reference is made. However, in cases where the OFT has not been informed directly of material facts about the merger, the four-month period is deemed to have commenced when material facts are ‘made public’, ie when they are ‘so publicised as to be generally known or readily ascertainable’.³² The OFT also has the power to ‘stop the clock’ in certain circumstances, for example where it is waiting for requested information from the merging parties.³³

3.3.10 Section 27(5) and 27(6) allow the Authorities to treat successive events within a period of two years involving the same parties (or in consequence of the same arrangements or transaction) as occurring simultaneously on the date of the latest event (see paragraph 3.2.17). The Authorities have discretion on whether or not to apply this section.

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 30 See *Archant Ltd/Independent News and Media plc*, CC, September 2004, Appendix C, paragraph 2.

31 See, for example, *Thermo Electron Manufacturing Limited/GV Instruments Limited*, CC, May 2007; and *Anticipated merger between NYSE Group Inc and Euronext NV*, OFT, October 2006.

32 Section 24.

33 Section 25.

Part 4

A substantial lessening of competition

Part 4 of the guidelines is set out in three sections. Section 4.1 describes what is meant by an SLC. Sections 4.2 and 4.3 outline the concepts of ‘theories of harm’ and ‘the counterfactual’ respectively.

■ Section 4.1: What is an SLC?

- 4.1.1 The term ‘substantial lessening of competition’ is not defined in the Act. What the Authorities mean by it and related terms is set out below.
- 4.1.2 Competition is viewed by the Authorities as a process of rivalry between firms seeking to win customers’ business over time by offering them a better deal. Rivalry creates incentives for firms to cut price, increase output, improve quality, enhance efficiency, or introduce new and better products because it provides the opportunity for successful firms to take business away from competitors, and poses the threat that firms will lose business to others if they do not compete successfully.
- 4.1.3 The Authorities will consider any merger in terms of its effect on rivalry over time in the market or markets affected by it. Many mergers are either pro-competitive or benign in their effect on rivalry. But when levels of rivalry are reduced, firms’ competitive incentives are dulled, to the likely detriment of customers. Some mergers will lessen competition but not substantially so because sufficient post-merger competitive constraints will remain to ensure that rivalry continues to discipline the commercial behaviour of the merger firms. A merger gives rise to an SLC when it has a significant effect on rivalry over time, and therefore on the competitive pressure on firms to improve their offer to customers or become more efficient or innovative. A merger that gives rise to an SLC will be expected to lead to an adverse effect for customers. Evidence on likely adverse effects will therefore play a key role in assessing mergers.
- 4.1.4 In broad terms, there are two types of merger:
- *horizontal mergers*: mergers between firms that supply competing products; and
 - *non-horizontal mergers*: mergers between firms that operate at different levels of the supply chain of an industry (vertical mergers) or mergers

between firms supplying products at the same level in the supply chain which do not compete (conglomerate mergers).

4.1.5 There are three main reasons why mergers may lead to an SLC:

- *Unilateral effects.* These may arise in horizontal mergers where the merger involves two competing firms and removes the rivalry between them, allowing the merged firm profitably to raise prices (see paragraphs 5.4.1 to 5.4.21).³⁴
- *Coordinated effects.* These may arise in both horizontal and non-horizontal mergers where the merger enables or increases the ability for several firms within the market (including the merged firm) jointly to increase price because it creates or strengthens the conditions under which they can coordinate (see paragraphs 5.5.1 to 5.5.19).
- *Vertical or conglomerate effects.* These may arise principally in non-horizontal mergers where the merger creates or strengthens the ability of the merged firm to use its market power in at least one of the markets, thus reducing rivalry (see paragraphs 5.6.1 to 5.6.15). However, these effects can, in some circumstances, also arise in horizontal mergers (see paragraphs 5.4.22 to 5.4.23).

4.1.6 In looking at horizontal mergers, the Authorities will generally focus on the impact of the merger on the market(s) in which the merger firms both supply goods and services. They may also consider the possible impact on other markets. In non-horizontal mergers, the Authorities will look at the impact of the merger on both the upstream and downstream markets and on any related markets (see paragraph 5.6.2). They will consider in particular the impact on rivalry in those markets and the possible foreclosure of markets to the merger firms' competitors or to firms in upstream or downstream markets.

■ Section 4.2: Theories of harm

4.2.1 Theories of harm are drawn up by the Authorities to provide the framework for assessing the effects of a merger and whether or not it could lead to an SLC. They describe possible changes arising from the merger, any impact on rivalry and expected harm to customers as compared with the situation likely to arise without the merger (referred to as the counterfactual, see section 4.3). The Authorities may revise the theories of harm as their assessment progresses.

4.2.2 The Authorities will seek to understand the commercial rationale for the transaction from the perspective of each of the parties concerned. They will routinely request background documentary evidence, including board papers and planning documents, from the parties so as better to understand how the transaction fits within the firms' wider commercial strategies, and in particular within the future strategy of the acquirer.

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³⁴ In mergers involving the acquisition of partial but not total control (see paragraphs 3.2.8 to 3.2.13) unilateral effects may arise from the reduction of rivalry between the merger firms rather than from its removal.

- 4.2.3 In formulating theories of harm, the Authorities will consider how rivalry might be affected. They may set out those aspects of the merger firms’ competitive offers to customers over which firms compete and which could worsen as a result of the merger, whether in terms of price or non-price aspects such as the quantity sold, service quality, product range, product quality and innovation. The ability of firms to adjust these aspects, and also the time within which they can do so, will depend upon the market concerned.
- 4.2.4 For some mergers, the Authorities may consider several theories, sometimes affecting the same market.³⁵ Consideration of multiple theories does not detract from the essential proposition that each Authority must determine whether, overall, it believes that there is a realistic prospect of an SLC (in the case of the OFT) or that an SLC is expected (in the case of the CC). (See also paragraph 2.3 and its footnote.)
- 4.2.5 The OFT’s reference test will be met when it considers there to be a realistic prospect of an SLC in respect of one or more of the theories it considers.³⁶
- 4.2.6 The CC’s assessment of the merger is not limited by the OFT’s conclusions on different theories of harm. The CC will determine whether an SLC arises or is expected to result from a merger, having considered one or more theories. It need not determine this in respect of each of the theories considered and its overall expectation of an SLC may be based upon one theory only or upon its composite view of multiple alternative theories. It will often be important to be clear about all the theories of harm that contribute to an SLC finding so as to ensure a properly focused assessment of remedies.

■ **Section 4.3: The ‘counterfactual’**

- 4.3.1 The application of the SLC test involves a comparison of the prospects for competition with the merger against the competitive situation without the merger. The latter is called the ‘counterfactual’.³⁷ The counterfactual is an analytical tool used in answering the question of whether the merger gives rise to an SLC. While based on evidence obtained by the Authorities in their investigations, it is generally not comparable in detail to their analysis of the competitive effects of the merger.
- 4.3.2 The description of the counterfactual is affected by the extent to which events or circumstances and their consequences are foreseeable, enabling the Authorities to predict with some confidence. The foreseeable period can sometimes be relatively short.³⁸ The Authorities may still consider the effects of the merger in the context of an event or circumstance occurring even if that event or

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35 These may include different effects on the same aspect of competition (for example, unilateral and coordinated effects on price), the same effects on different competitive aspects (for example, unilateral effects on price and on quality), or different effects on different aspects (for example, unilateral effects on price and coordinated effects on innovation). These theories of harm may apply over different time periods—for example, short-run unilateral effects on price and long-run coordinated effects on innovation.

36 These theories may be mutually exclusive.

37 Developments which have arisen or are likely to arise as a result of the merger will not form part of the counterfactual assessment but will be examined as part of the SLC test.

38 For example, *British Salt Ltd/New Cheshire Salt Works Ltd*, CC, November 2005.

circumstance is not sufficiently certain to include in the counterfactual.³⁹ Future changes in market conditions, such as regulation or market liberalisation, are often addressed as part of the Authorities' competitive assessment.

- 4.3.3 A counterfactual cannot be constructed that involves violations of competition law, eg a cartel.
- 4.3.4 Since the counterfactual may be either more or less competitive than the prevailing conditions of competition, the selection of the appropriate counterfactual may increase or reduce the prospects of an SLC finding by the relevant Authority.

The Authorities' approach to the counterfactual

- 4.3.5 In reviewing mergers at Phase 1, the OFT is required to assess whether the merger creates a realistic prospect of an SLC. The 'is or may be the case' standard in the OFT's SLC test also has implications for its approach to the counterfactual. The OFT considers the effect of the merger compared with the most competitive counterfactual providing always that it considers that situation to be a realistic prospect. In practice, the OFT generally adopts the prevailing conditions of competition (or the pre-merger situation in the case of completed mergers) as the counterfactual against which to assess the impact of the merger.⁴⁰ However, the OFT will assess the merger against an alternative counterfactual where, based on the evidence available to it, it considers that the prospect of prevailing conditions continuing is not realistic (eg because the OFT believes that one of the merger firms would inevitably have exited from the market) or where there is a realistic prospect of a counterfactual that is more competitive than prevailing conditions.
- 4.3.6 As a Phase 2 body, the CC takes a different approach since it has to make an overall judgement on whether or not an SLC has occurred or is likely to occur. To help make this judgement on the likely future situation in the absence of the merger, the CC may examine several possible scenarios, one of which may be the continuation of the pre-merger situation; but ultimately only the most likely scenario will be selected as the counterfactual. When it considers that the choice between two or more scenarios will make a material difference to its assessment, the CC will carry out additional detailed investigation before reaching a conclusion on the appropriate counterfactual.⁴¹ However, the CC will typically incorporate into the counterfactual only those aspects of scenarios that appear likely on the basis of the facts available to it and the extent of its ability to foresee future developments; it seeks to avoid importing into its

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39 Such an approach by the CC was supported by the Appeal Court judgment *BSkyB and Virgin Media v Competition Commission and BERR* [2010] EWCA Civ 2, paragraph 55; <http://www.bailii.org/ew/cases/EWCA/Civ/2010/2.html>. The OFT, in its competitive effects analysis, will not take account of possibilities (for example, future entry plans of the target company) that it has dismissed at the counterfactual stage as being fanciful, although it might have regard to facts that are insufficient for it to adopt a counterfactual other than the pre-merger conditions (for example, by taking account of the reduced competitive impact of a firm in financial difficulties even though the conditions of the exiting firm scenario are not met).

40 See *Anticipated acquisition by Tesco Stores Limited of five former Kwik Save stores (Handforth, Coventry, Liverpool, Barrow-in-Furness and Nelson)*, OFT, December 2007.

41 For inquiries in which the assessment of the counterfactual played an important part, see, for example, *Stagecoach Group plc/Preston Bus Limited*, CC, November 2009, and *Ticketmaster/Live Nation*, CC, May 2010.

assessment any spurious claims to accurate prediction or foresight. Given that the counterfactual incorporates only those elements of scenarios that are foreseeable, it will not in general be necessary for the CC to make finely balanced judgements about what is and what is not the counterfactual (but see also paragraph 4.3.2 and footnote 39).

4.3.7 The most notable examples of situations where the Authorities may use a counterfactual different from the prevailing conditions of competition are:

- the exiting firm scenario;
- the loss of potential entrant scenario; and
- where there are competing bids and parallel transactions.

■ *The exiting firm scenario*

4.3.8 In forming a view on an exiting firm scenario, the Authorities will consider:

- (a) whether the firm would have exited (through failure or otherwise); and, if so
- (b) whether there would have been an alternative purchaser for the firm or its assets to the acquirer under consideration; and
- (c) what would have happened to the sales of the firm in the event of its exit.

4.3.9 The exiting firm scenario is most commonly considered when one of the firms is said to be failing financially. However, exit may also be for other reasons, for example because the selling firm's corporate strategy has changed. When considering any exiting firm argument, the Authorities will be particularly interested in evidence that has not been prepared in contemplation of the merger. It may be particularly important in the context of an exiting firm scenario for the Authorities to understand the rationale for the transaction under review (ie to consider why the purchaser is acquiring a firm or assets that it is claimed would, in any event, have exited from the market).⁴²

4.3.10 For the OFT to accept an exiting firm argument, it would need (on the basis of compelling evidence) to believe that it was inevitable that the firm would exit the market and be confident that there was no substantially less anti-competitive purchaser for the firm or its assets (ie considerations (a) and (b) in paragraph 4.3.8). The OFT would then consider whether, having regard also to consideration (c), the result of the exit of the firm and its assets would be a substantially less anti-competitive outcome than the merger. If the OFT concludes that there is no realistic prospect of a substantially less anti-competitive alternative to the merger under consideration (taking account of all three considerations), it will conclude that there is no realistic prospect of an SLC arising. Having taken its counterfactual into account any loss of competition cannot therefore be attrib-

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⁴² Information on the rationale for the transaction may be relevant for considerations of different theories of harm by the Authorities outside the context of the exiting firm scenario (see paragraph 4.2.2).

uted to the merger under review.⁴³ If the OFT cannot reach a sufficient level of confidence in relation to each of the considerations (a),(b) and (c), it will use the pre-merger situation as its counterfactual to assess the merger.

- 4.3.11 The three considerations (a) to (c) are relevant to the CC's identification of an appropriate counterfactual. Having identified the most appropriate counterfactual, the CC will generally consider the implications of (a) to (c) as part of its SLC analysis. If the CC considers that there were alternative purchasers, it will try to identify who the alternative purchaser(s) might have been and take this into account when determining the counterfactual. The analysis of the impact on competition of the merger (ie whether the effect of the merger under review would be substantially less competitive than the effect of an acquisition by an alternative purchaser) would be part of the SLC analysis. Similarly, how the merger compares to the effect of exit of the firm and the dispersal of its sales is treated as part of the consideration of the effects of the merger on competition.
- 4.3.12 Practical considerations relating to the three questions listed in paragraph 4.3.8 are examined below.

(a) Would the firm have exited?

- 4.3.13 The Authorities will look at the facts of the case to assess whether one of the firms would have exited.
- 4.3.14 In the context of a firm exiting for reasons of financial failure, consideration is given both to whether the firm is unable to meet its financial obligations in the near future and to whether it is unable to restructure itself successfully. The Authorities will examine the firm's balance sheet to determine the profile of assets and liabilities. They will also consider the action the management has taken to address the firm's position and will review contemporaneous documents such as board minutes, management accounts and strategic plans.⁴⁴
- 4.3.15 If the firm was a part of a larger corporate group, the Authorities will look at the nature and value of the transactions within that group to determine the extent to which the losses were caused by intra-group charges, and whether the transactions were on arm's length terms. The Authorities will apply the same principle in determining whether a particular subsidiary or division would have exited the market without the merger. They will examine the evidence as to why the parent company would have closed that subsidiary or division. Such cases require particularly careful analysis. There may be several reasons why a profitable parent company would not close down a subsidiary or division which appeared to be loss-making. For example, the allocation of costs within a business may mean that the accounts for the division may not reflect actual operating cash flow, or the division may have some strategic or other value that is not reflected in the accounts.

.....
 43 For an example of the OFT using a counterfactual other than prevailing conditions, see *First West Yorkshire/Black Prince*, OFT, May 2005.

44 Examples of how the Authorities have considered accounting and documentary evidence in practice include *Long Clawson Dairy Limited/The Millway business of Dairy Crest Group plc*, CC, January 2009, and *Completed acquisition by Home Retail Group plc of 27 stores from Focus (DIY) Ltd*, OFT, April 2008.

(b) Would there have been an alternative purchaser for the firm or its assets?

- 4.3.16 Even if the Authorities believe that the firm would have exited, there may be other buyers whose acquisition of the firm as a going concern, or of its assets, would produce a better outcome for competition than the merger under consideration. These buyers may be interested in acquiring the firm or its assets as a means of entering the market.
- 4.3.17 When considering the prospects for an alternative buyer for the firm or its assets, the Authorities will look at available evidence supporting any claims that the merger under consideration was the only possible merger (ie that there was genuinely only one possible purchaser for the firm or its assets). The Authorities will take into account the prospects of alternative offers for the business above liquidation value. The possible unwillingness of alternative purchasers to pay the seller the asking purchase price would not rule out a counterfactual in which there is a merger with an alternative purchaser.

(c) What would have happened to the sales of the exiting firm?

- 4.3.18 If the Authorities believe that the firm and its assets would have exited, they will consider what would have happened to the sales of the firm. They will consider whether sales would have been redistributed among the firms remaining in the market and, if so, how. If sales were likely to have been dispersed across several firms, the merger, by transferring most or all of the sales to the acquirer, may have a significant impact on competition. If, on the other hand, the majority of the sales were expected to have switched to the acquiring firm, the merger may have little effect on competition.

■ ***Loss of potential entrant scenario***

- 4.3.19 The Authorities will consider whether the counterfactual situation should include the entry by one of the merger firms into the market of the other firm or, if already within the market, whether the firm would have expanded had the merger not taken place.⁴⁵

■ ***Competing bids and parallel transactions***

- 4.3.20 Where there is more than one bidder for a target business, the OFT will examine each competing bid separately and will consider whether each proposed merger would create a realistic prospect of an SLC as against prevailing conditions of competition. It will not engage in a comparative analysis of multiple competing bids.
- 4.3.21 For the CC, the appropriate counterfactual will depend on the circumstances of the case.

.....
 45 For an example of the OFT considering potential entry into the market by one of the merger firms, see *Air France-KLM/VLM*, OFT, May 2008.

One proposed transaction is referred

4.3.22 If only one merger is referred, the counterfactual used by the CC may be the pre-merger competitive situation or the sale of the target firm to one of the alternative purchasers. When deciding on the most appropriate counterfactual, the CC will consider the circumstances of the sale, including the offers of the alternative purchasers.

Two or more bids are referred

4.3.23 If two or more merger situations involving competing bids are referred to the CC, but there are other merger situations involving other bids that are not, the counterfactual is more likely to involve a merger that is not referred (and therefore does not give rise to competition concerns) than one of the referred mergers which does raise competition concerns. Depending on the circumstances, the appropriate counterfactual may be based on either the sale to an alternative bidder whose bid has not been referred or the prevailing conditions of competition. The CC would not take into account the possibility of remedies being implemented to address competition concerns raised by the alternative mergers, ie a sale to a 'remedied bidder' would not become the counterfactual situation (but see paragraphs 4.3.28 and 4.3.29 on rail franchise awards).

4.3.24 Where mergers involving all the bids are referred, the counterfactual will often be the pre-merger situation, although before identifying it as such, the CC will consider the appropriateness of the counterfactual being the acquisition by another purchaser that does not raise competition concerns. This entails considering the circumstances of the case, including the likelihood of acquisition by a purchaser who was not one of the bidders.

Parallel transactions

4.3.25 The Authorities may be required to consider a merger at a time when there is the prospect of another merger in the same market (a parallel transaction⁴⁶).

4.3.26 For the OFT, the question is, as always, whether the transaction under review creates the realistic prospect of an SLC, and it is likely to consider whether the statutory test would be met whether or not the parallel transaction proceeds⁴⁷ (unless the parallel transaction can clearly be ruled out as too speculative⁴⁸). As explained in paragraph 1.17, given the Act's voluntary notification regime, the Authorities, when assessing a merger, cannot ignore a parallel transaction on the grounds that it has not been notified to the OFT, or was notified after the merger under review.

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46 A parallel transaction is considered as part of the counterfactual on the basis that it would occur whether or not the merger takes place. In this context, a parallel transaction is one which is either anticipated or which has been completed but remains subject to the possibility of being unwound as a result of intervention by the Authorities under the Act.

47 See *Anticipated acquisition by Nasdaq Stock Market, Inc of the London Stock Exchange plc*, OFT, January 2007, in which the OFT included the merger between NYSE and Euronext as part of its counterfactual notwithstanding that that merger had not yet completed.

48 The OFT considered that a successful completed bid by Nasdaq for LSE was too speculative to be taken into account as part of the counterfactual in *Anticipated merger between NYSE Group, Inc. and Euronext N.V.*, OFT, October 2006.

4.3.27 Parallel transactions do not have to be referred to the CC simultaneously. They may come to it at different times. The CC does not give consideration of one referred merger automatic priority over another. When determining the relevant counterfactual for one of the referred mergers the CC will take into account whether or not it expects the other transaction to proceed.

Rail franchise awards

4.3.28 In rail franchise cases, the pre-merger situation cannot be the appropriate counterfactual, as the existing rail franchise is coming to an end and a new franchise must be awarded to one of the short-listed bidders.⁴⁹

4.3.29 The Authorities will therefore treat the appropriate counterfactual to the merger as the award of the franchise either to a firm that raises no competition concerns, or, if there is no alternative bidder that does not raise competition concerns, to a hypothetical bidder, with any competition concerns being remedied through behavioural remedies.⁵⁰

.....
49 See, for example, *Stagecoach/East Midlands passenger rail franchise*, OFT, February 2008.

50 See *Greater Western Passenger Rail Franchise*, CC, February 2006.

Part 5

Analytical approach and methodologies

Part 5 of the guidelines describes the general analytical approach and the methodologies commonly used to conduct the SLC assessment. However, as emphasised in Part 1, the SLC assessment is inevitably case-specific, and will depend on the particular transaction and the individual markets being analysed.

■ Section 5.1: Introduction

- 5.1.1 The Authorities' assessment of the SLC test is framed in terms of two related issues. The first concerns the identification of the market or markets for the goods or services concerned. The second concerns the Authorities' assessment of the competitive effects of the merger in the market(s). In practice, the analysis of these two issues will overlap, with many of the factors affecting market definition being relevant to the assessment of competitive effects and vice versa. Therefore, market definition and the assessment of competitive effects should not be viewed as two distinct analyses.
- 5.1.2 In considering the SLC test, the Authorities generally conduct their analysis under the following headings (although the headings are not necessarily systematically followed in the Authorities' decisions or reports):
- (a) market definition;
 - (b) measures of concentration;
 - (c) horizontal mergers—unilateral effects (including any vertical effects of horizontal mergers);
 - (d) horizontal mergers—coordinated effects;
 - (e) non-horizontal mergers—unilateral and coordinated effects;
 - (f) efficiencies;
 - (g) entry and expansion; and
 - (h) countervailing buyer power.
- 5.1.3 The extent of the analysis conducted on each of these aspects, and the evidence considered as part of that analysis, is likely to vary according to whether the

merger is being considered by the OFT at Phase 1 or the CC at Phase 2. Given the role of the OFT at Phase 1, the statutory reference test and the reduced time available, its ability to undertake detailed analysis of all issues may be limited. Further, when considering efficiencies, prospects for entry and expansion and countervailing buyer power, and having regard to the realistic prospect threshold, the OFT will require compelling evidence if it is to conclude on the basis of these factors that the merger should not be referred to the CC.

- 5.1.4 During the assessment of mergers by either Authority, parties will be asked, or choose, to provide evidence. When submitting evidence of a technical nature to the Authorities, especially survey evidence or econometric estimates, parties should include any necessary data, descriptions of methodology, and algorithms to enable the Authorities to assess their analysis.⁵¹ The CC sometimes undertakes its own econometric analysis (either in the light of analysis produced by the merger firms or of its own accord); the OFT is less likely to do so.

■ Section 5.2: Market definition

- 5.2.1 The purpose of market definition is to provide a framework for the Authorities' analysis of the competitive effects of the merger. The Authorities will identify the market within which the merger may give rise to an SLC (the relevant market). The relevant market contains the most significant competitive alternatives available to the customers of the merger firms and includes the sources of competition to the merger firms that are the immediate determinants of the effects of the merger (ie the Authorities' aim when identifying the relevant market is to include the most relevant constraints on behaviour of the merger firms). The Authorities will ensure that the relevant market they identify satisfies the hypothetical monopolist test (see paragraphs 5.2.9 to 5.2.20).
- 5.2.2 Market definition is a useful tool, but not an end in itself, and identifying the relevant market involves an element of judgement. The boundaries of the market do not determine the outcome of the Authorities' analysis of the competitive effects of the merger in any mechanistic way. In assessing whether a merger may give rise to an SLC the Authorities may take into account constraints outside the relevant market, segmentation within the relevant market, or other ways in which some constraints are more important than others.
- 5.2.3 The relevant market may not be the narrowest market that meets the hypothetical monopolist test. However, to the extent that they use them, the Authorities will not normally have regard to market share and concentration thresholds calculated on anything other than the narrowest market that satisfies the hypothetical monopolist test (see paragraph 5.3.5).

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51 Suggested best practice for the submission of technical economic analysis from parties is at: www.competition-commission.org.uk/rep_pub/corporate_documents/corporate_policies/best_practice.pdf; and www.competition-commission.org.uk/press_rel/2009/feb/pdf/07-09.pdf. As at September 2010, the Authorities are conducting a public consultation on a joint good practice guide for parties on how to design and present consumer survey evidence; see http://www.competition-commission.org.uk/about_us/our_organisation/workstreams/analysis/Good%20Practice%20CC3.htm.

- 5.2.4 Reflecting the different functions of the two Authorities, the OFT will usually make an initial assessment of the boundaries of the relevant market but may not reach a conclusion, while the CC will usually reach a conclusion on the boundaries of the relevant market in cases referred to it. In this section reference is made throughout to ‘defining’ the relevant market but this should be read taking into account the differences between the two Authorities’ approaches.
- 5.2.5 There are normally two dimensions to the definition of the relevant market: a product dimension and a geographic dimension. Markets may also be defined by reference to customer group or temporal factors.
- (a) The relevant product market is a set of products that customers consider to be close substitutes, for example in terms of utility, brand or quality.
 - (b) The relevant geographic market: may be local, regional, national or wider. Imports may be taken into account as well as UK products.
 - (c) The relevant customer market: when suppliers can target higher prices at those customers willing to pay more than others (ie price discriminate), the market may be defined by customer group, with the customers in each market being offered different terms. When different suppliers can meet customers’ requirements at different times, the relevant customer market may have a temporal dimension.

■ ***(a) Defining the product market***

- 5.2.6 In identifying the relevant product market the Authorities will pay particular regard to demand side factors (the behaviour of customers and its effects). However, they may also consider supply-side factors (the capabilities and reactions of supplier in the short term) and other market characteristics.

(i) Demand-side factors

- 5.2.7 The relevant product market is identified primarily by considering the response of customers to an increase in the price of one of the products of the merger firms (demand-side substitution). The evidence the Authorities may consider when evaluating the closeness of competition between different products is described at paragraph 5.2.15.
- 5.2.8 The Authorities use the ‘hypothetical monopolist test’ as a tool to check that the relevant product market is not defined too narrowly. The relevant product market may potentially be wider than the narrowest market that satisfies the hypothetical monopolist test.

Hypothetical monopolist test

- 5.2.9 Paragraphs 5.2.10 to 5.2.20 explain the use of the hypothetical monopolist test by reference to the relevant product market. The test is also similarly relevant to other aspects of the market (eg the geographic market).

- 5.2.10 A set of substitute products (a ‘candidate market’) will satisfy the hypothetical monopolist test if a hypothetical firm that was the only present and future seller of the products in the candidate market would find it profitable to raise prices. Under this framework, a candidate market will fail the hypothetical monopolist test, and will be too narrow to comprise the relevant market, if customers would respond to the price rise by switching to products outside the set to such an extent that the price increase by the hypothetical monopolist would not be profitable.
- 5.2.11 When selecting a candidate market in horizontal mergers (see paragraph 4.1.4), the Authorities will include at least the substitute products (narrowly defined) of the merger firms. In non-horizontal mergers (see also paragraph 4.1.4), the Authorities will include at least one of the products of the merger firms. In applying the hypothetical monopolist test, the Authorities will assess whether the hypothetical monopolist could profitably raise the price of at least one of the products in the candidate market by at least a small but significant amount over a non-transitory period of time (ie by a ‘SSNIP’—a small but significant and non-transitory increase in price).
- 5.2.12 When applying the hypothetical monopolist test, the Authorities will normally use a SSNIP of 5 per cent, though they may sometimes use a higher or lower number. In most cases, a hypothetical monopolist test would be conducted relative to prevailing prices. In cases where it is thought that prevailing prices might be the outcome of coordinated behaviour, the Authorities may consider conducting the test using prices lower than prevailing prices as a starting point.
- 5.2.13 The hypothetical monopolist test is based on the possibility that a price increase becomes less costly when a group of previously competing products is brought under the control of a hypothetical monopolist. It is costly for the supplier of one of the products to raise the price beforehand because it will lose the profit on sales diverted as a result. The cost is composed of two elements:
- (a) the profit on lost sales from customers who switch to other products in the candidate market; and
 - (b) the profit on lost sales from customers who switch to other products outside the candidate market.
- 5.2.14 If the products in the candidate market are, hypothetically, brought under the control of a single supplier, it is no longer as costly for that supplier to raise the price of any of the products; it will recoup the profit on recaptured sales from those customers that switch to other products in the candidate market.
- 5.2.15 Accordingly the Authorities may consider evidence on the following factors when evaluating whether a SSNIP by the hypothetical monopolist would be profitable.
- (a) Closeness of substitution. If the products in the candidate market are close substitutes, the hypothetical monopolist test is more likely to be satisfied because the hypothetical monopolist will recapture a significant share of the sales lost in response to a SSNIP, making the price rise less costly. The

closeness of substitution between products can be indicated by the diversion ratio or cross-price elasticity of demand between them.⁵² Evidence used to assess the closeness of substitution between products may include:

- information about product characteristics such as physical properties and intended use that can indicate similarities between different products;
- information about relative price levels and the extent to which prices of products within the candidate market are correlated with each other, as compared with the prices of products outside the candidate market;
- information on prices and sales volumes over time or across areas that permit analysis of the way that customers respond to changes in prices or to firms entering and leaving the market;⁵³
- responses from customers, competitors and interested and informed third parties to questions—sometimes posed in surveys—about customer behaviour and the hypothetical monopolist test; and
- documents such as marketing studies, consumer surveys prepared in the normal course of business, market analyses prepared for investors, and internal business analyses (eg board papers, business plans and strategy documents).

(b) Variable profit margins (sales revenue minus direct costs of sales). If the variable profit margins of the products in the candidate market are high, the hypothetical monopolist test is more likely to be satisfied because the value of the sales recaptured by the hypothetical monopolist will be greater, making the price rise less costly. Evidence about variable margins can come from internal documents containing accounting information. Evidence that customers are very sensitive to price can also indicate low variable profit margins.

(c) Price sensitivity of customers. If customers are insensitive to changes in the price of products in the candidate market, the hypothetical monopolist test is more likely to be satisfied because the SSNIP will not lead to many lost sales, making the price rise less costly. The own-price elasticity of demand can be an indication of the extent to which customers switch away from a product when its price increases.⁵⁴ Evidence that can inform the Authorities about the closeness of substitution of the products in the candidate market will often also be useful in providing information about the overall sensitivity of customers to price. Information enabling the estimation of ‘switching costs’, if any, that customers might incur in changing from the product of one supplier to that of another can also be relevant.

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52 A diversion ratio between Product A and Product B represents the proportion of sales that would divert to Product B (as opposed to Products C, D, E etc) as customers’ second choice in the event of a price increase for Product A. The cross-price elasticity of demand of Product A to Product B is a measure of the percentage change in the quantity of Product A sold when the price of Product B rises by 1 per cent.

53 See, for example, *Completed acquisition by Tesco plc of five stores (Thurso, Bedlington, Little Lever, Ramsbottom and North Hykeham) from Somerfield plc*, OFT, December 2007.

54 The own-price elasticity of demand for a product is a measure of the percentage change in quantity sold for a 1 per cent change in the price charged.

5.2.16 Information gathered on these factors may be supplemented by other information and by calculations which can help the Authorities judge how likely it is that a SSNIP would be profitable.⁵⁵

(ii) Supply-side factors

5.2.17 The boundaries of the relevant product market are generally determined by reference to demand-side substitution alone. However, there are circumstances where the Authorities may aggregate several narrow relevant markets into one broader one on the basis of considerations about the response of suppliers to changes in prices. They may do so when:

- production assets can be used by firms to supply a range of different products that are not demand-side substitutes, and the firms have the ability and incentive quickly (generally within a year) to shift capacity between these different products depending on demand for each; and
- the same firms compete to supply these different products and the conditions of competition between the firms are the same for each product; in this case aggregating the supply of these products and analysing them as one market does not affect the Authorities' decision on the competitive effect of the merger.⁵⁶

5.2.18 An example of where the Authorities may aggregate products which are not demand-side substitutes is in markets characterised by bidding and tendering processes where firms bid on the basis of the service they can offer to supply customers with bespoke products. The competitive constraint on firms in this case comes from a customer's willingness to award the contract to a rival rather than to switch to a different bespoke product. Aggregating a range of contracts where the same set of firms would have been credible bidders can provide more useful information about the competitive constraints on each firm than is available from focusing on just one bespoke product.⁵⁷

5.2.19 The evidence that Authorities may consider in deciding whether to aggregate markets includes:

- information on adjustment costs and variable profit margins for those suppliers being considered;
- information on the production processes involved and the extent of spare capacity within the industry;
- information about the distribution systems of the different suppliers, and the ease and speed with which they can increase their sales volume for a product if they increase the capacity devoted to it;

55 See, for example, *Long Clawson Dairy Limited/The Millway business of Dairy Crest Group plc*, CC, January 2009, and *Anticipated acquisition by LOVEFILM International Limited of the online DVD rental subscription business of Amazon Inc.*, OFT, April 2008.

56 See, for example, *Stagecoach Group plc/Eastbourne Buses Ltd*, CC, October 2009, and *Anticipated merger between Grainfarmers Group and Centaur Grain Group*, OFT, October 2008 (paragraphs 13 and 14).

57 See, for example, *Anticipated acquisition by Nike, Inc. of Umbro plc*, OFT, January 2008 (paragraphs 10 to 12).

- evidence that most suppliers supply many of the products and that they routinely shift production capacity between products in response to variations in price differentials over time; and
- evidence that suppliers earn similar variable profit margins on the different products, and that the margins move together over time.

(iii) Other market characteristics

5.2.20 Depending on the characteristics of the market, the Authorities may take into account additional factors in their market definition. Some examples of such factors follow:

- *Indirect competition.* The Authorities may consider widening the relevant product market, to include products that are not directly substitutable because of indirect competition. This can happen, for example, when the merger firms make inputs used in different production processes to make the same output. If the merged firm imposed a SSNIP on one of the inputs, it may make the associated technology more expensive, leading to higher sales by suppliers that use the competing technology, and greater demand for the inputs made by the other merger firm. In practice, the extent to which indirect switching constitutes an important factor when defining the relevant product market depends on: (i) how competitively the final product is supplied; (ii) how competitively the input is supplied; (iii) how competitively other, complementary inputs are supplied; and (iv) what proportion of the total cost of the output is accounted for by the input.
- *Two-sided products.* The implementation of the hypothetical monopolist test may be more complicated when products are two-sided. Two-sided products are platforms (such as newspapers and other media) that intermediate between distinct and unrelated groups of customers. The number of customers in each group affects the profitability of the product, because the value that one group of customers realizes from using the intermediary depends on the volume of customers from the other group ('indirect network effects').⁵⁸ Prices charged to each set of customers take account of the need to get both sets 'on board'. It may therefore be difficult to conduct a hypothetical monopolist test because: (i) there is no single price to both sets of customers to which to apply a SSNIP;⁵⁹ (ii) the effect of a SSNIP on the demand of one set of customers may be exacerbated by indirect network effects; and (iii) the constraints on the merger firms' products may come not only from other two-sided intermediaries but also from 'one-sided' firms serving one set of customers.⁶⁰

58 For example, in newspaper (and other media) markets both readers (or viewers, or listeners) and advertisers are served and the value of the product (eg an advertisement) to one group of customers (advertisers) is affected by the number of customers served in the other group (the number of readers of a newspaper, listeners to a radio station or viewers of a television channel).

59 For example, some newspapers are advertising-funded and free to readers whereas others charge both advertisers and readers.

60 An example is radio broadcasting where commercial radio stations serve both advertisers (who pay to advertise) and listeners (who do not pay) but where BBC radio stations – which also provide free content to listeners – do not serve advertisers. See, for example, *Completed acquisition by Global Radio UK Ltd of GCap Media plc*, OFT, August 2008.

- *Secondary products.* The Authorities may consider combining primary and secondary products in the same relevant product market. Secondary (or aftermarket) products are those that are purchased only as a result of the customer having purchased a primary product. Examples include spare parts for cars and razor blades for razors. There are three situations:
 - (a) If customers predominantly buy the primary and secondary product from the same supplier, the Authorities may sometimes define a single system market in which suppliers of systems of primary and secondary products compete. This is especially likely to be the case where customers consider the price of both products (ie the system) when making their initial purchase decision.
 - (b) If each primary product is associated with a range of secondary products which are compatible with it—but not with other primary products—the Authorities may define one market for the primary products and multiple secondary markets, each one containing the secondary products which are compatible with one primary product. Sometimes the same firm supplies both a primary product and one of the secondary products which are compatible with it. In these cases the Authorities may have regard to the indirect constraints imposed in the secondary markets from competition in the primary market.
 - (c) If most secondary products are generally compatible with a range of different primary products, the Authorities may define two markets: one for the primary products, and one for the secondary products.
- *Self-supply.* When identifying the relevant product market, special considerations can arise when some firms buy their inputs in a merchant market (ie from independent, third party suppliers) while others meet their own requirements. The Authorities will consider whether production of the input used for self-supply by the merger firms should be included in the relevant market for assessing any effects on input prices. The Authorities will generally follow the principle that captive production by the firms will be included in the relevant market only if it can be demonstrated that it would be profitable for the supplier to forgo its use and sell into the merchant market in response to a SSNIP. The Authorities will also consider whether self-supply by potential customers of the merger firms should be included in the relevant market. The Authorities will generally include self-supply if the ability of customers to choose this option affects the profitability of a price rise by the hypothetical monopolist.
- *Asymmetric constraints.* The boundaries of the relevant product market may depend on the identity of the products in the candidate market. In particular, where products are differentiated, the competitive constraints they impose on each other need not be symmetric. In other words, a hypothetical product A may constrain product B's prices while product B's prices have no effect on product A. An example of this is grocery retailing, where larger stores might

constrain the prices of smaller stores while the reverse may not be true.⁶¹ One consequence of this is that the relevant product market in different merger cases in the same sector may not coincide, so a merger of small grocery stores may take place in a market that includes large grocery stores but a merger of large grocery stores may take place in a market that does not include small grocery stores.

■ *Defining the geographic market*

5.2.21 The Authorities will also define the relevant geographic market. There are similarities between their approaches to defining the relevant geographic market and to defining the relevant product market. Both use the hypothetical monopolist test (see paragraphs 5.2.9 to 5.2.16) as a tool to check that the relevant market is not too narrowly defined (see paragraph 5.2.8). Relevant geographic markets may be based on the location of suppliers or customers.

5.2.22 In cases where prices (and sometimes delivery costs) are listed, rather than being subject to negotiation, a relevant geographic market may be based on the location of suppliers and if so would be defined as an area covering a set of suppliers or outlets that customers consider to be substitutes for the supplier or outlet of interest. Such a supplier-based geographic market may often be appropriate when customers travel to a supplier's location to purchase products.

5.2.23 Where available, similar information to that used to identify demand-side substitution between products can be used to assess the geographic boundaries of the relevant market.⁶² In particular, the Authorities may consider the following:

- product characteristics such as perishability;
- information on differences in pricing, sales, advertising and marketing strategies by area;
- information enabling the estimation of 'switching costs' (which can include additional delivery costs) that customers might incur in changing to products that are currently supplied in other geographic areas relative to the value of the products and the length of time taken to make the switch;
- responses from customers, competitors and interested and informed third parties to questions—sometimes posed in surveys—on consumer preferences by geographic area; and
- information on flows of goods between regions or into the UK and any barriers to entry, whether legislative, natural or strategically created.

61 See, for example, *Somerfield plc/Wm Morrison Supermarkets plc*, CC, September 2005, and *Anticipated acquisition by Co-operative Group Limited of Somerfield Limited*, OFT, October 2008, and *Tesco/Co-op Store acquisition in Slough*, CC, November 2007.

62 For an analysis of some of these types of information in the context of national (ie UK-wide) geographic market definition, see for example, *Arcelor SA and Corus Group plc*, CC, February 2005 and *Greif Inc and Blagden Packaging Group*, CC, August 2007. For an analysis of some of these types of information in the context of a regional geographic market definition, see, for example, *Stericycle International LLC and Sterile Technologies Group Ltd*, CC, December 2006 and *Wienerberger Finance Service BV and Baggeridge Brick plc*, CC, May 2007.

- 5.2.24 The Authorities may aggregate several narrow relevant geographic markets into a single broader one on the basis of the expected response of suppliers to changes in price. When determining whether there is scope to do so, the Authorities may consider similar information to that used to identify supply-side substitution between products, with particular focus on the transport costs incurred by suppliers.
- 5.2.25 When assessing mergers involving a large number of local geographic markets—for example, mergers of grocery retailers operating over multiple localities—the Authorities may examine the geographic catchment area within which the great majority of a store’s custom is located. Catchment areas are a pragmatic approximation for a candidate market to which the hypothetical monopolist test can be applied; the use of catchment areas is not an alternative conceptual approach. However, the geographic market identified using the hypothetical monopolist test will typically be wider than a catchment area. Consequently, if the impact of the merger on concentration in this catchment area appears unproblematic, then the Authorities may exclude the local area from further analysis without concluding on the boundaries of that particular relevant geographic market.
- 5.2.26 The Authorities will also consider whether customers would increase their purchases from overseas suppliers if domestic producers’ prices were increased (perhaps suggesting that the relevant market was wider than the UK). Even when imports account for a small proportion of UK consumption, it might be relatively easy for customers to switch. However, there can be obstacles facing customers wanting to purchase more from overseas or overseas producers wanting to increase their UK supply, for example transport costs, capacity constraints, trade barriers and national standards or regulations.
- 5.2.27 In cases where delivered prices are negotiated individually with customers, the geographic scope of a relevant market will be one aspect of the definition of the relevant customer market. This may mean that, when suppliers can price discriminate on the basis of customer location, the Authorities may define separate relevant geographic markets by customer location and not by supplier location. Such a customer-based geographic market may often be appropriate when suppliers deliver products to a customer’s location where:
- demand or supply conditions differ between those locations; and
 - arbitrage between those locations is difficult.

■ *Defining customer markets*

- 5.2.28 The Authorities may sometimes define relevant markets for separate customer groups if the effects of the merger on competition to supply a targeted group of customers may differ from its effects on other groups of customers, and require a separate analysis. This may happen when, for example, suppliers can target higher prices at customers willing to pay more, or when competition for customers differs significantly between different customer groups. Intermediate

goods markets where suppliers negotiate individually with customers provide some examples of markets where suppliers may be able to target higher prices at customers willing to pay more, although price discrimination can occur in final markets too. In some cases the prices customers pay will vary because they are buying different products.

5.2.29 In determining whether there are separate customer groups, the key question is whether some customers could get better terms for the same requirements. In such instances, depending on the circumstances of the case, the Authorities may decide to define two or more relevant markets, or they may decide to define only one relevant market and note the scope for price discrimination within it.

5.2.30 In assessing the breadth of relevant markets defined by customer groups, the Authorities may consider a range of factors. For example, the Authorities may define narrow relevant markets by customer group when:

- customers who pay a low price cannot resell to those who would otherwise pay a high price;
- suppliers can identify those with a high willingness to pay, or those in a weak bargaining position, and therefore can adopt a different negotiating stance towards them; and
- customers have different preferences, or have access to different sets of suppliers.

5.2.31 Customer markets may also be defined on the basis of temporal markets, for example where customers are not able to substitute products between time periods (eg due to the seasonality of product supply or the different prices for peak and off-peak services).

■ Section 5.3: Measures of concentration

5.3.1 As part of their assessment of the effects of a merger on competition, the Authorities may use market shares and measures of concentration, assessed on the relevant market or some other market (in particular the narrowest market that satisfies the hypothetical monopolist test). Where such measures are considered for the purpose of applying thresholds, the narrowest market defined by the hypothetical monopolist test must be employed (see paragraph 5.3.5).

5.3.2 When interpreting information on market shares and concentration the Authorities may have regard to the following factors:

- The extent to which products are differentiated (ie similar but not perfect substitutes for one another) and some products are closer competitors to each other than to others in terms of, for example, branding, quality, characteristics or geographical location.⁶³

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63 An over-reliance on concentration measures to indicate changes in market power, in particular where products are differentiated, has been termed the 'binary fallacy': the assumption that all firms in the market exercise competitive constraints upon one another in proportion to their market shares, but that firms outside the market exercise no constraint at all.

- Whether there is evidence of turbulence in concentration (eg movements in market shares over time), which may indicate intense dynamic competition, regardless of the static level of concentration in a market.
- How widely the market is drawn. A low combined market share on the narrowest market that satisfies the hypothetical monopolist test will be a better indicator of an absence of potential competition concerns than the same share on a market that is drawn more widely.
- The level of variable profit margins. If margins are high the same market shares can indicate greater potential price effects from the merger than otherwise (see paragraph 5.2.15 (b)).

5.3.3 Concentration can be measured using such data as sales revenue, production volume, capacity or reserves. The measure the Authorities will use will depend on the facts of the case and the availability of information. For example, when products differ in quality it may be appropriate to use sales revenue as the basis. If different suppliers make the same, or similar, products capacity may be a significant determinant of a firm's competitive strength and may be a more appropriate basis of assessment.

5.3.4 There are several ways in which concentration can be measured.

- Market shares of firms in the market, both in absolute terms and relative to each other, can give an indication of the potential extent of a firm's market power. The combined market shares of the merger firms, when compared with their respective pre-merger market shares, can provide an indication of the change in market power resulting from a merger. In horizontal mergers in markets involving undifferentiated products, unilateral effects are more likely where the merger results in a firm with a large market share.
- Number of firms. A straightforward count of the firms in a market is a basic measure of concentration. The Authorities may attach greater weight to the number of firms when considering coordinated effects. When assessing unilateral effects from local markets of mergers involving retailers, a count of the number of different fascias in a local area also conveys some information about concentration (see paragraph 5.2.25). However, counting firms or fascias does not take into account differences in market shares and the size distribution of firms.
- Concentration ratios measure the aggregate market share of a small number (three or four generally) of the leading firms in a market (eg the three-firm concentration ratio, or C3, shows the proportion of the market supplied by the three leading firms). The ratios are absolute in value and take no account of differences in the relative size of the firms that make up the leading group.
- The Herfindahl-Hirschman Index (HHI) is a measure of market concentration that takes account of the differences in the sizes of market participants, as well as their number. The HHI is calculated by adding together the squared values of the percentage market shares of all firms in the market. The change

in the HHI (known as the ‘delta’) can be calculated by subtracting the market’s pre-merger HHI from its expected post-merger HHI.⁶⁴ The absolute level of the HHI post-merger and the delta arising from the merger can provide an indication of the change in market structure resulting from the merger.

5.3.5 *Thresholds.* Given its role as a Phase 1 body, the OFT may have regard to market share and concentration thresholds. However, to the extent that the OFT uses and relies on them, it does not do so mechanistically and will normally not have regard to market share and concentration thresholds on anything other than the narrowest market that satisfies the hypothetical monopolist test. Past OFT decisions illustrate circumstances in which the OFT is less likely to identify competition concerns on the basis of these thresholds.

- In relation to market shares, previous OFT decisions in mergers in markets where products are undifferentiated suggest that combined market shares of less than 40 per cent will not often give the OFT cause for concern over unilateral effects. At the time of writing there have been too few OFT decisions in non-horizontal mergers to suggest a threshold in these cases. For such mergers, therefore, the OFT may have regard to the thresholds in the European Commission’s guidelines on the assessment of non-horizontal mergers. In particular, a market share for the merged firm of less than 30 per cent will not often give the OFT cause for concern over input foreclosure (see discussion in paragraphs 5.6.9 to 5.6.12).
- In relation to the number of firms, previous OFT decisions in mergers involving retailers suggest that the OFT has not usually been concerned about mergers that reduce the number of firms in the market from five to four (or above).
- As regards the HHI, the OFT may have regard to the following thresholds:⁶⁵ any market with a post-merger HHI exceeding 1,000 may be regarded as concentrated and any market with a post-merger HHI exceeding 2,000 as highly concentrated. In a concentrated market, a horizontal merger generating a delta of less than 250 is not likely to give cause for concern. In a highly concentrated market, a horizontal merger generating a delta of less than 150 is not likely to give cause for concern. These thresholds may be most informative for mergers in a market where the product is undifferentiated and where competition between firms involves firms choosing what volume to supply to the market. In other cases the significance of these thresholds will be less.

5.3.6 In cases where capacity is key to assessing concentration, the Authorities will pay particular attention to two issues.

64 A market of four firms with market shares a, b, c and d will have an HHI of $a^2 + b^2 + c^2 + d^2$. The delta in the HHI in this market arising from a merger between the two firms with market shares a and b can be shown to be equal to $2ab$.

65 These thresholds are in line with those in the European Commission’s guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings—Commission notice (2004/C31/03).

- (a) Whether firms may use some of their capacity to make alternative products. If so, the Authorities will include only the capacity that they expect would be made available to supply the product in question in response to a SSNIP within a short period of time (normally within a year). In making their assessment of this capacity, the Authorities may consider the commercial incentives on the firms to shift capacity in this way, as well as any evidence about their response in the past to changes in the price of the product in question (see paragraphs 5.2.17 to 5.2.19).
- (b) Whether there are particular firms with the capacity to make the product in question within a short period of time (normally within a year), but which currently do not do so. If there are such firms (sometimes termed ‘rapid entrants’) their capacity may be included. The Authorities will make an assessment of which firms they expect would participate in the market, and the capacity that would be attributed to each firm, based upon an assessment of the capacity that each firm would make available to supply the product in question in response to a SSNIP.

Current measures may also be adjusted to reflect imminent changes that are expected, such as the addition of extra capacity.

■ Section 5.4: Horizontal mergers—unilateral effects

- 5.4.1 Unilateral effects can arise in a horizontal merger when one firm merges with a competitor that previously provided a competitive constraint, allowing the merged firm profitably to raise prices on its own and without needing to coordinate with its rivals. Unilateral effects can be horizontal or vertical.

Horizontal unilateral effects

- 5.4.2 A theory of harm relevant to the consideration of horizontal unilateral effects is the loss of existing competition. Other theories of harm consider the unilateral effects arising from the elimination of potential competition (see paragraphs 5.4.13 to 5.4.18) and from increased buyer power (see paragraphs 5.4.19 to 5.4.21).
- 5.4.3 Paragraphs 5.4.4 to 5.4.12 explain the theory relating to the loss of an existing competitor through a merger, for undifferentiated and differentiated products respectively.

■ *Loss of existing competition*

Undifferentiated products

- 5.4.4 Where products are undifferentiated, unilateral effects are more likely where: the market is concentrated; there are few firms in the affected market post-merger; the merger results in a firm with a large market share (see paragraph 5.3.4); and there is no strong competitive fringe of firms.
- 5.4.5 Unilateral effects resulting from the merger are more likely where the merger eliminates a significant competitive force in the market. For example, the

merger may involve a recent entrant or a firm which was expected to grow into a significant competitive force or otherwise to provide a significant competitive threat to other firms in the market (eg by virtue of having a novel business model or a reputation for aggressive price cutting). Unilateral effects are more likely where customers have little choice of alternative supplier, for example because of the level of ‘switching costs’⁶⁶ or network effects (see paragraph 5.2.20 on two-sided products).

Differentiated products

5.4.6 Where products are differentiated, for example by branding or quality, unilateral effects are more likely where the merger firms’ products compete closely. To assess whether the merger results in unilateral effects, the Authorities may analyse the change in the pricing incentives of the merger firms created by bringing their differentiated products under common ownership or control.

5.4.7 Unilateral effects may arise because a price increase becomes less costly when the products of the two firms are brought under common ownership or control. Without the merger, it is costly for one of the merger firms to raise its prices because it will lose the profit on diverted sales as a result. The cost is composed of two elements:

- (a) the profit on lost sales from customers who switch to the products of the other merger firm; and
- (b) the profit on lost sales from customers who switch to the products of firms other than the other merger firm.

5.4.8 After the merger it is no longer as costly for the merged firm to raise the price of any of the products: it will recoup the profit on recaptured sales from those customers who would have switched to the products of the other merger firm.

5.4.9 The factors taken into account for the assessment of horizontal unilateral effects fall under the headings below (see paragraphs 5.2.9 to 5.2.20 on the hypothetical monopolist test).

(a) *Closeness of substitution*. If the products of the merger firms are close substitutes, unilateral effects are more likely because the merged firm will recapture a significant share of the sales lost in response to the price increase, making the price rise less costly. The diversion ratio from the product of one of the merger firms to the other is a useful indicator of the ability of the second product to constrain the prices of the first product (see paragraph 5.2.15 (a)).

(b) *Variable profit margins* (see paragraph 5.2.15 (b)). If the variable profit margins of the products of the merger firms are high, unilateral effects are more likely because the value of sales recaptured by the merged firm will be greater, making the price rise less costly.

.....
 66 See, for example, *FMC Corporation/ISP Holdings (U.K.) Limited*, OFT, July 2008.

(c) *Price sensitivity of customers.* If customers are insensitive to changes in the price of the merger firms' products, unilateral effects are more likely because the price rise will not lead to many lost sales, making the price rise less costly. The own-price elasticity of demand can be an indication of the extent to which customers switch away from a product when the price increases.

5.4.10 Information gathered on these factors may be supplemented by other information and by calculations which can help the Authorities judge how likely it is that a price rise by the merged firm would be profitable.⁶⁷

5.4.11 The potential response of other suppliers to any attempt by the merged firm to increase price can also have an effect on pricing incentives. In evaluating whether the price rise by the merged firm would be profitable, the Authorities may also therefore take into account the short-term responses of competing suppliers, and any limitations on such responses. For example:

- competing suppliers may respond to a price rise by the merged firm by raising their own prices; this response is likely to make the price rise more profitable than otherwise; and
- competing suppliers may not have the capacity to meet demand from some customers who would like to switch in response to the price rise; this may also make the price rise more profitable than otherwise.

5.4.12 As with undifferentiated products, unilateral effects resulting from the merger are more likely where the merger eliminates a significant competitive force in the market or where customers have little choice of alternative suppliers (see paragraph 5.4.5).

■ *Loss of potential competition*

5.4.13 Unilateral effects may also arise from the elimination of potential competition. There are two ways in which the removal of a potential entrant could lessen competition by weakening the competitive constraint on an incumbent supplier.

5.4.14 The first way is where the merger involves a potential entrant that could have increased competition. Such 'actual potential competition' is a constraint only if and when entry occurs.

5.4.15 In assessing whether a merger leads to unilateral effects from a loss of 'actual potential competition', the Authorities will consider the following questions:

- (a) Would the potential entrant be likely to enter in the absence of the merger (see discussion regarding the counterfactual, paragraphs 4.3.19 to 4.3.29)?
- (b) Would such entry lead to greater competition?

.....
⁶⁷ See, for example, *Somerfield plc/Wm Morrison Supermarkets plc*, CC, September 2005; *Completed acquisition by Home Retail Group plc of 27 stores from Focus (DIY) Ltd*, OFT, April 2008; *Anticipated acquisition by Co-operative Group Limited of Somerfield Limited*, OFT, October 2008.

The Authorities will also consider whether there are other potential entrants before reaching a conclusion on the SLC test (see Section 5.8 of these guidelines: Barriers to entry and expansion.)

5.4.16 Second, the merger may remove a firm which is not in the market, but which nevertheless imposes an existing constraint because of the threat that it would enter if existing firms in the market raised their prices. A constraint from such ‘perceived potential competition’ may arise even though the Authorities do not believe that entry would actually occur.

5.4.17 A firm is more likely to provide a constraint as a perceived potential competitor if its entry can take place without incurring any substantial sunk costs, and if it can happen within a year, though the Authorities’ assessment in any case will take account of the particular aspects of the market in question.

5.4.18 In assessing whether a merger leads to unilateral effects from a loss of perceived potential competition, the Authorities will consider whether the presence of perceived potential competition resulted in the pre-existing prices of the incumbent firm (or firms) being lower than they would otherwise have been.

■ **Increased buyer power**

5.4.19 Where the merger firms purchase the same products, the merged firm may enjoy greater buyer power (or monopsony power) than the merger firms could previously exert individually. In many cases, an increase in buyer power is not likely to give rise to unilateral effects; and some of the benefits to the firm from its greater buyer power may be passed on to the merged firm’s customers.

5.4.20 One circumstance in which unilateral effects may arise from increased buyer power is when:

- the merged firm has an incentive to lower the amount it purchases so as to reduce the purchase price it pays (known as ‘demand withholding’⁶⁸); and
- the merged firm also has sufficient market power over its customers so that, as it reduces the quantity sold to them in the market, it can increase the price at which it sells to them.

5.4.21 Buyer power may also lead to suppliers having lower incentives to invest in new products and processes.

Vertical effects of horizontal mergers

5.4.22 Mergers which are principally horizontal in character may have vertical effects if one or more of the merger firms also operate at a different level of the supply chain for a good or service.⁶⁹ The merged firm will generally need to have a significant position in the market for an SLC to arise from vertical effects. If both

68 See, for example, *Stonegate Farmers Limited/Deans Food Group Limited*, CC, April 2007.

69 See, for example, *BOC Limited/Ineos Chlor Limited*, CC, December 2008.

merger firms act at more than one level of the supply chain, the merger may be characterised as a horizontal merger between two vertically-integrated firms.⁷⁰

5.4.23 In assessing the vertical effects of a horizontal merger, the Authorities will use the same approach as in assessing a purely vertical merger (see Section 5.6).

■ Section 5.5: Horizontal mergers—coordinated effects

5.5.1 A merger may give rise to an SLC through coordinated effects. Coordinated effects may arise when firms operating in the same market recognise that they are mutually interdependent and that they can reach a more profitable outcome if they coordinate to limit their rivalry.

5.5.2 Coordination may take different forms. In many instances, it will involve firms keeping prices higher than they would otherwise have been in a more competitive market. However, coordination can in principle affect any aspect of competition, eg by limiting production or innovation. Firms may coordinate by dividing up the market between them, for example by geographic area or customer characteristics, or by allocating contracts among themselves in bidding competitions. However, coordination need not involve all aspects over which firms compete.

5.5.3 Coordination can be explicit or tacit. Explicit coordination is achieved through communication and agreement between the parties involved. Tacit coordination is achieved through implicit understanding between the parties, but without any formal arrangement. Both can be germane to an assessment of the effects of a merger.

5.5.4 When assessing coordinated effects, the Authorities will analyse the characteristics of the market that could be conducive to coordination. They will examine whether there is evidence that the firms in the market were coordinating pre-merger. If so, they will examine whether the merger makes coordination more stable or effective, given the characteristics of the market. If there is no evidence of pre-merger coordination, they will examine whether the merger makes it more likely that firms in the market will start to coordinate, given the characteristics of the market.

■ *Pre-existing coordination*

5.5.5 Evidence relating to pre-existing coordination will be considered when assessing whether the merger gives rise to coordinated effects. The significance of whether there was or was not pre-existing coordination will depend on the facts of the case.

5.5.6 There may be evidence to suggest that the market was coordinated before the merger. For example, prices or market shares pre-merger may be hard to reconcile with non-coordinated behaviour;⁷¹ and there may be evidence (eg

⁷⁰ See, for example, *London Stock Exchange plc*, CC, November 2005.

⁷¹ Identifying coordinated outcomes on this basis may be difficult. Whilst coordination may result in price parallelism, intense price competition often also does so.

from combining information on demand elasticities and variable profit margins) that current prices are at collusive levels because firms, if they were acting unilaterally, would profit if they undercut the current price. If so, this may imply that the three conditions for coordination (see paragraph 5.5.9) were met pre-merger.

5.5.7 Past proven or suspected cartel actions in the same relevant product market may also indicate that the conditions for coordination were met in that market, although this inference cannot automatically be drawn. In markets which are not obvious candidates for tacit coordination according to the conditions in paragraph 5.5.9, past cartel behaviour (ie explicit coordination) may suggest that tacit coordination is difficult. Conversely, past cartel behaviour may provide an indicator of the likelihood of tacit coordination where:

- the operation of the cartel establishes or strengthens one of the conditions for coordination; and
- the type of cartel behaviour observed is the same as the type of tacit coordination anticipated.⁷²

5.5.8 If in their view the pre-merger market showed (tacitly or explicitly) coordinated outcomes, the Authorities will consider whether the conditions for coordination have been strengthened or weakened as a result of the merger. In general, a merger in a market already showing coordinated outcomes would be likely to make coordination more sustainable or more effective, unless the structure and scale of the merged firm is so different from those of its predecessors that the incentive to coordinate has been removed.

■ **Market characteristics conducive to coordination**

5.5.9 As well as considering whether or not there is evidence of pre-existing coordination, the Authorities will analyse the characteristics of the market for evidence of the ability to coordinate. All three of the following conditions must be satisfied for coordination to be possible:

- (a) Firms need to be able to reach and monitor the terms of coordination.
- (b) Coordination needs to be internally sustainable among the coordinating group—ie firms have to find it in their individual interests to adhere to the coordinated outcome.
- (c) Coordination needs to be externally sustainable, in that there is little likelihood of coordination being undermined by competition from outside the coordinating group.

(a) Ability to reach and monitor the terms of coordination

5.5.10 For coordination to emerge, the firms involved need to be able to reach a common understanding about their objectives (for example, a price below

⁷² For example, an explicit agreement to share local markets geographically may lay down ground rules for tacit coordination in the future over, say, subsequent store openings.

which they would not sell). Such an understanding need not involve explicit communication; for example, the terms of coordination might emerge over time through repeated interaction.

5.5.11 In assessing whether the firms in a market would be able to reach an understanding on the terms of coordination, the Authorities may consider, for example:

- the number of firms in the market—the fewer firms, the easier it will be to reach an understanding; and
- the degree of complexity in the environment in which firms interact—the more complex this environment, the more difficult it will be for firms to reach a common understanding (in particular for tacit coordination). The degree of complexity will depend on the number and type of products sold and the number of aspects of competition over which firms compete (eg price or non-price factors), as well as the extent to which firms differ in their capabilities, product portfolios, customer mix and strategies. Where there are fewer products and the aspects of competition over which the firms compete are simpler, it may be easier for the firms in the market to identify a focal point around which to coordinate.

5.5.12 To sustain coordination, firms will generally need to be able to monitor each other's behaviour sufficiently to ensure that deviation from the coordinated outcome can be detected. Price transparency will typically assist such monitoring, but is not a necessary factor for coordination to be sustained.

5.5.13 In assessing whether firms are likely to be able to monitor an understanding post-merger, the Authorities may consider:

- evidence on the ease with which firms can detect the choices of their rivals. The analysis will depend on the particular theory of coordinated effects being investigated. For example, an understanding in relation to the allocation of customers may be feasible even if the firms in the market cannot observe each other's prices. The Authorities may also consider whether firms can infer their rivals' actions from market outcomes even if they cannot observe them directly. For example, a firm's knowledge of its own or competitors' sales volumes and capacities might, in some contexts, provide enough information to determine whether or not deviation from coordination is taking place; and
- the number of firms; it will generally be easier for a firm to know what its rivals are doing when there are fewer of them.

5.5.14 The existence of significant structural links between firms in the market (such as being each other's customers or suppliers, holding cross-shareholdings or belonging to trade associations) may also assist in reaching and monitoring the terms of coordination.

(b) Internal sustainability

5.5.15 Coordination will be sustainable only where the additional profit from coordination is sufficiently high, and there is an effective mechanism to punish deviation. If coordination is not sufficiently profitable, or the punishment is not sufficiently swift and painful, a firm may prefer to deviate. It might do so if the short-term gain that the firm makes from having a more competitive offer than the coordinating firms outweighs the costs to it of future punishment. Such punishment may take the form of a reversion to more intense competition by the other firms rather than a deliberate punitive strategy on their part.

5.5.16 In assessing whether the coordination would be internally sustainable, the Authorities will consider, for example:

- how swiftly punishment would follow on from deviation, and whether customers can encourage deviation by offering long-term contracts (which prevent immediate punishment by fixing the terms of firms' competitive offers during the period of the contract);
- the extent to which punishing the deviating firm is, or would be, costly to other coordinating firms;
- the number of firms—all else being equal, the greater the number of firms, the larger the profit that deviation produces and the less sustainable coordination becomes. Additionally, the cost to the deviating firm of punishment (ie forgone profits from coordination) is lower when those profits are shared between more firms; and
- whether there are significant asymmetries between firms—where this is the case, firms which are dissimilar to each other have weaker incentives to coordinate. For example, it may not be in the interests of larger coordinating firms to retaliate when faced with a small deviating rival, if this would eliminate profits from coordination in the market as a whole. This lack of an incentive to retaliate can undermine coordination.

(c) External sustainability

5.5.17 Coordination will be sustainable only if the outside competitive constraints on the firms involved in coordination are relatively limited. It is not necessary for all firms in the market to be involved in coordination but those firms which coordinate need to be able collectively to exercise a degree of market power.

5.5.18 In assessing whether coordination would be externally sustainable the Authorities may consider:

- whether existing competitors outside the coordinating group (the competitive 'fringe') can take significant business from the coordinating group. External sustainability will typically be easier where the competitive fringe does not impose a strong competitive constraint and is unlikely to be able to expand;

- whether there are barriers to entry. If barriers to entry are high, coordination is more likely to be sustainable;
- whether customers have buyer power. Coordination is more likely to be sustainable if customers have little or no countervailing buyer power; and
- whether there is a maverick. Coordination will be harder to sustain where there is a firm with substantially different incentives to coordinate than its rivals, and with the capacity to take significant share from any group of firms that tried to coordinate without its participation. Such a firm is sometimes termed a 'maverick'. For example, a firm might value having a reputation for offering the lowest price in the market, and might consider itself likely to sacrifice profits in the long term if it were to lose that reputation by coordination. Whatever the cause of its behaviour, a maverick may be particularly disruptive to coordination.

■ *Effect of the merger*

5.5.19 The Authorities will consider the impact of the merger on the likelihood and effectiveness of coordination. In doing so, the Authorities will consider the effect of the merger of any or all of the three conditions in paragraph 5.5.9. For example, as the number of firms in the market falls, it becomes easier to reach agreement and monitor compliance. The incentives to sustain coordination will also be higher in markets with few firms since any deviation will be relatively easily detectable. Similarly, where a merger results in greater symmetry in a market, this can make it easier to reach and monitor the terms of coordination. The incentives to sustain coordination will also be higher in a symmetric market, as the costs of punishing deviation are borne more evenly across the coordinating group.

■ **Section 5.6: Non-horizontal mergers**

5.6.1 Non-horizontal mergers (see paragraph 4.1.4) bring products together that do not themselves compete but may be related. They include vertical mergers (including diagonal mergers) and conglomerate mergers. Non-horizontal mergers do not involve a direct loss of competition between firms in the same market, and it is a well-established principle that most are benign and do not raise competition concerns. Nevertheless, some can weaken competition and may result in an SLC.

5.6.2 Examples of situations in which products are related so that the Authorities may assess whether a merger gives rise to an SLC on the basis of non-horizontal effects include where there is a:

- vertical merger between an upstream supplier and a downstream customer which purchases the supplier's goods, either as an input into its own production or for resale;
- diagonal merger between an upstream supplier and a downstream competitor of the customers that purchase the supplier's goods; and

- conglomerate merger of two suppliers of goods which do not lie within the same market, but which are nevertheless related in some way; for example because they are complements (so that a fall in the price of one good increases the customer's demand for another); or because there are economies of scale in purchasing them (so that customers buy them together).

5.6.3 Any given merger can have aspects of more than one of the above. For example, a merger may be characterised as part vertical and part diagonal in terms of its effects on competition.

5.6.4 Non-horizontal mergers can lead to efficiencies (see section 5.7, in particular paragraphs 5.7.10 and 5.7.11), and this may result in the merged firm having increased incentives to compete to take business from rivals. This greater incentive to compete can result in an increase in rivalry.

5.6.5 However, under certain conditions, non-horizontal mergers can weaken rivalry. The theories of harm raised by such mergers typically involve the merged firm harming the ability of its rivals to compete post-merger, for example by raising effective prices to its rivals, or by refusing to supply them completely. Such actions may harm the ability of the merged firm's rivals to provide a competitive constraint into the future.

5.6.6 Despite differences in detail between cases, the Authorities will typically frame their analysis of non-horizontal mergers by reference to the following three questions:

- Ability*: Would the merged firm have the ability to harm rivals, for example through raising prices or refusing to supply them?
- Incentive*: Would it find it profitable to do so?
- Effect*: Would the effect of any action by the merged firm be sufficient to reduce competition in the affected market to the extent that, in the context of the market in question, it gives rise to an SLC?

5.6.7 In practice, the analysis of these questions may overlap and many of the factors may affect more than one question. Therefore, the Authorities' analysis of ability, incentive and effect may not be in distinct chronological stages but rather as overlapping analyses. So as to reach an SLC finding, all three questions must be answered in the affirmative.

5.6.8 The following paragraphs, 5.6.9 to 5.6.12, illustrate how the Authorities might consider these questions in relation to a vertical merger where the theory of harm relates to the consideration of partial input foreclosure. The subsequent paragraphs, 5.6.13 and 5.6.14, outline the approach the Authorities might take to some other theories of harm arising from non-horizontal mergers.

■ *Analysing partial input foreclosure*

5.6.9 By way of illustration, this section considers how the Authorities would approach a vertical merger between an upstream input provider and a downstream manufacturer of a final product. The theory of harm to be assessed is that the merged firm could increase the price it charges for the input to rival manufacturers. This in turn would make it harder for rival manufacturers to compete by increasing their costs, making them less competitive. Competition in manufacturing may thus be lessened.

Ability

5.6.10 In assessing the ability of the merged firm to engage in partial input foreclosure, the Authorities may consider evidence on the following factors:

- (a) *The cost of the input relative to all costs of the final product.* All else being equal, if the input accounts for only a small part of the total costs incurred, the merged firm will be less able to harm its rival manufacturers' ability to compete than if the input accounts for a greater part of the total costs.
- (b) *The extent to which rival manufacturers can avoid a price increase by switching away from this input.* If downstream rivals can turn to many good substitutes for the input, the merged firm will be less able to impose a price increase than if there were few alternative providers of the input.
- (c) *Pass-through of cost increases.* The Authorities will consider the extent to which any increases in the costs of the input to rival manufacturers would be passed on to customers of the final product.

Incentive

5.6.11 To assess whether the merged firm would have an incentive to increase the prices charged for the input to its rival manufacturers, the Authorities will consider the factors affecting the profitability of such an increase in the input price, and the extent to which these factors change as a result of the merger. In particular, the Authorities may assess the following:

- (a) *Loss of profits in the input market.* The merged firm increases the input price but loses sales of the input as rival manufacturers switch to alternatives for the input. This switching will be more costly to the merged firm if competition in the input market is intense.
- (b) *Gain in profits in the market for the final product.* The merged firm gains from partial input foreclosure if it forces rival manufacturers to raise their prices for the final product, and, as a result, customers in the market for the final product switch to the merged firm's own final product. This benefit will be reduced if:
 - customers in general do not react strongly to changes in prices for the final product (for a discussion on types of evidence on the closeness of

substitution and the price sensitivity of demand, see paragraph 5.2.15);
and

- the merged firm’s final product is a poor substitute for those made by rival manufacturers, so that the diversion ratio to the merged firm is low (for a discussion of evidence on the diversion ratio, see paragraph 5.2.15).

(c) *The relative level of variable profit margins on the input and the final product.*
If variable profit margins are higher in absolute terms for the input than for the final product, the negative impact on profitability of lost sales in the input market may outweigh the positive impact on profitability of additional sales in the market for the final product.

Effect

5.6.12 To the extent that the merged firm has both the ability and incentive to increase prices so as to foreclose to some extent its rival manufacturers, the Authorities will consider the impact of such foreclosure on competition in the downstream market. The Authorities may also need to take account of any stimulus to rivalry in the downstream market that may arise as a result of efficiencies from the merger.

■ **Analysing other situations and theories of harm**

5.6.13 The Authorities will adapt the approach described in paragraphs 5.6.9 to 5.6.12 when considering other situations and theories of harm. The following are examples:

- *Total input foreclosure.* In some cases, the merged firm may stop supplying its rivals altogether. This has the effect of reducing the set of suppliers available to rival manufacturers, which might in turn effectively reduce competition in the input market leading to higher input prices for rivals and potentially other harmful effects. In evaluating the ability of the merged firm to engage in total input foreclosure, the Authorities may consider how easily the merged firm can commit not to re-enter the input market, for example by adopting an input technology that is incompatible with the production techniques of rival manufacturers of the final product.
- *Customer foreclosure.* In mergers involving a manufacturer and a distributor, the merged firm might increase retail prices when selling rivals’ products (partial customer foreclosure), or stop stocking rivals’ products altogether (total customer foreclosure), thereby diverting customers to its own products. The Authorities’ approach to analysing the ability, the incentive and the effect of customer foreclosure is analogous to that for input foreclosure. In particular, an SLC arising from customer foreclosure will only be possible where:
 - it affects an important route to market, and the merged firm has a significant position in the distribution market;

- the merged firm has the incentive to engage in customer foreclosure because the profit gained by the merged firm from selling more of its manufactured goods exceeds the profit lost from customers who switch to a different distributor; and
 - the impact of such customer foreclosure on the upstream market would be significant in terms of rivalry, taking due account of any efficiencies that enhanced the merged firm’s own incentives to compete
- *Conglomerate mergers.* Such mergers can raise concerns that the merged firm might increase the selling price of one of its products when sold on a stand-alone basis, but might not do so if customers buy both the merged firm’s products; this would give customers an incentive to buy the second product from the merged firm as well, putting rivals in the second product market at a disadvantage. The Authorities’ approach involves analysing the ability, incentive and the effect of this strategy. This takes into account the following factors: (i) whether customers have a demand for more than one of the products, and whether the products are complements; (ii) customer preferences for variety and one-stop shopping; and (iii) the costs to rivals of providing variety and one-stop shopping at a scale to enable them to compete effectively with the merged firm.
 - *Diagonal mergers.* A diagonal merger could, for example, arise where there are two competing manufacturers in the market for the final product, which use two different technologies, and where the merger is between a supplier of the input for use in one technology and the manufacturer that uses the competing technology. The merged firm could harm rivals of its downstream manufacturing arm by raising the prices it charges for the input to the rival manufacturer. The Authorities’ approach to analysing the ability, incentive and effect of this strategy may take into account: (i) whether the input is an important component of the final product; (ii) whether the merged firm has a significant position in the input market; and (iii) how closely rivals’ final products compete with the merged firm’s final product. In this type of non-horizontal merger there is less scope for pricing efficiencies than in standard vertical mergers.
 - *Commercially sensitive information.* Vertical mergers may allow the merged firm to gain access to commercially sensitive information about the activities of non-integrated rivals in the input market or the market for the final product, allowing it unilaterally to compete less aggressively in the market for the final product or otherwise to put rivals at a competitive disadvantage.⁷³

5.6.14 In certain situations, foreclosure may involve behaviour that is unlawful under competition law. In assessing how this might impact on the incentive to carry out the behaviour in question, the Authorities may take into account whether the behaviour would be clearly, or highly probably, unlawful; whether the behaviour

73 See, for example, *Anticipated acquisition by Boots Group plc of Alliance UniChem plc*, OFT, May 2006. See also *BSkyB/ITV*, CC, December 2007, where such a theory of harm was raised but not relied upon, and subsequently dismissed.

would be likely to be detected; and the potential consequences of such behaviour (eg enforcement action taken by the OFT).

■ *Coordinated effects arising from non-horizontal mergers*

5.6.15 Non-horizontal mergers, like horizontal mergers, may create or strengthen co-ordinated effects. In assessing the potential for coordinated effects arising from a non-horizontal merger, the Authorities will adopt the same general framework as for horizontal mergers, ie they will consider whether the conditions for coordination are met following the merger, and the effect of the merger on the likelihood and effectiveness of coordination (see section 5.4 of these Guidelines on Horizontal mergers—coordinated effects). However, the details of the analysis of the impact of the merger may differ. The following are some examples of the ways that non-horizontal mergers could affect coordination:

Vertical mergers

- A vertical merger may allow the merged firm to gain access to commercially sensitive information about the activities of non-integrated rivals; this can facilitate coordination.
- Furthermore, a vertical merger that results in foreclosure could reduce the number of players in the affected market, making it easier for the remaining players to coordinate. A vertical merger may also increase the level of symmetry (eg in costs, if other firms in the market also are vertically integrated) and/or transparency in the market (eg by giving input producers control of the prices of final products), making it easier to reach and monitor a coordinated outcome.
- In addition, a vertical merger may better align the incentives of firms in the market to maintain coordination (eg by enabling the vertically integrated firm to punish deviation more effectively if it becomes an important supplier to, or customer of, other firms in the market after the merger). A vertical merger may also increase barriers to entry, which can reduce the scope for entry to disrupt coordination, or it may reduce buyer power if it involves the acquisition of a customer who would otherwise disrupt coordination (see Section 5.9 of these guidelines).

Conglomerate mergers

- A conglomerate merger may also create or strengthen coordinated effects in several ways. For example, it may strengthen the incentives to coordinate by enhancing the ability to agree on the collusive outcome, by increasing the scope of punishment and by increasing the ability to detect deviations. Foreclosed rivals may choose not to contest the situation of coordination, but may prefer instead to benefit from the increased price level.
- In addition, conglomerate firms may compete against each other in multiple markets. Where firms interact frequently, across multiple markets, they may be more likely to be able to develop coordinating strategies. Deviation

from the coordinated outcome in one market can be punished in another market, where the punishment hurts more, or in all markets. As the number of markets affected by the merger increases, the information available on market conditions also increases and detection of deviation may become easier. A conglomerate merger that increases contact between rivals in multiple markets may therefore enhance the likelihood of coordination.

■ Section 5.7: Efficiencies

- 5.7.1 While mergers can harm competition, they can also give rise to efficiencies.
- 5.7.2 Efficiencies arising from the merger may enhance rivalry, with the result that the merger does not give rise to an SLC. For example, a merger of two of the smaller firms in a market resulting in efficiency gains might allow the merged entity to compete more effectively with the larger firms.
- 5.7.3 The Act also enables efficiencies to be taken into account in the form of relevant customer benefits.⁷⁴ These benefits are defined in [section 30\(1\)](#), and are not limited to efficiencies affecting rivalry. In addition, the statutory definition enables the Authorities to take into account benefits to customers arising in markets other than where the SLC is found, and benefits to future customers.
- 5.7.4 It is not uncommon for merger firms to make efficiency claims. To form a view that the claimed efficiencies will enhance rivalry so that the merger does not result in an SLC, the OFT must be satisfied, on the basis of compelling evidence, and the CC must expect, that the following criteria will be met:
- (a) the efficiencies must be timely, likely and sufficient to prevent an SLC from arising (having regard to the effect on rivalry that would otherwise result from the merger); and
 - (b) the efficiencies must be merger specific, ie a direct consequence of the merger, judged relative to what would happen without it.⁷⁵
- 5.7.5 Efficiency claims can be difficult for the Authorities to verify because most of the information concerning efficiencies is held by the merger firms. The Authorities therefore encourage the merger firms to provide evidence to support any efficiency claims whether as part of the SLC analysis or the consideration of relevant customer benefits.

Types of efficiencies

- 5.7.6 The types of efficiencies may broadly be characterised as supply-side efficiencies, such as cost savings, or demand-side efficiencies, such as increased network size. Examples are provided below. In general, whether an

⁷⁴ The statutory framework for the treatment of relevant customer benefits by the Authorities differs, and each Authority has guidance explaining this treatment. See the OFT publication *Mergers—exceptions to the duty to refer and undertakings in lieu of reference* (OFT1122) (to be published), and paragraphs 1.14 to 1.20 of CC8, *Merger Remedies: Competition Commission Guidelines*.

⁷⁵ The criteria of timeliness, likelihood and sufficiency, on the one hand, and merger specificity, on the other hand, are also germane to a consideration of efficiencies in the context of relevant customer benefits; see OFT publication *Mergers—exceptions to the duty to refer and undertakings in lieu of reference* (OFT1122) (to be published), and paragraphs 1.16 to 1.17 of CC8, *Merger Remedies: Competition Commission Guidelines*.

efficiency is considered as part of the assessment of the SLC or as a relevant customer benefit will depend on the facts of the case.

■ *Supply-side efficiencies*

5.7.7 Supply-side efficiencies arise if the merged firm can supply its products at lower cost as a result of the merger. Common examples of supply-side efficiencies are:

- cost reductions;
- the removal of double marginalization in vertical mergers;
- solving the ‘investment hold-up’ problem; and
- product repositioning.

Cost reductions

5.7.8 There are several ways in which horizontal, vertical and conglomerate mergers may give rise to efficiencies in the form of cost savings. For example:

- The merged firm may benefit from economies of scale (from having a larger scale of operations) or economies of scope (eg from the joint supply of different products). Either of these can also produce reductions in fixed costs.
- The merged firm may be able to benefit, across its portfolio of products, from the more efficient production processes or working methods of one of the merger firms.
- Vertical mergers may improve the coordination of upstream production and downstream distribution, leading to lower transaction and inventory costs.

5.7.9 The Authorities are more likely to take cost savings into account where efficiencies reduce marginal (or short-run variable) costs as these tend to stimulate competition and are more likely to be passed on to customers in the form of lower prices. The Authorities will not in general give as much weight to savings in fixed costs because they may often represent private gains to firms and are less important in short-run price formation, although reductions in fixed costs may play an important role in longer-term price formation.

Removal of double marginalization

5.7.10 Vertical mergers may allow the merged firm to remove (‘internalise’) any pre-existing double mark-ups. These arise when, pre-merger, firms supplying the input and producing the final product set their prices independently and both charge a mark-up, resulting in prices to customers for the final product being higher than would suit the joint interests of both firms. A vertical merger may enable, and provide incentives for, the merged firm to internalise this double mark-up resulting in a decrease in the price of the final product.

- 5.7.11 In some cases double marginalisation may not be significant pre-merger. This may be the case, for example, if existing vertical supply agreements include a price mechanism which eliminates the mark-up on the input.

Solving the 'investment hold-up' problem

- 5.7.12 A supply-side efficiency that may arise in vertical mergers results from aligning the incentives within the merged firm to invest in, for example, new products, new processes or marketing. For instance, a distributor of the manufactured products of a firm further up the supply chain may be reluctant to invest in promoting those products because its investment may also benefit competing distributors/retailers. A vertical merger can alleviate this 'investment hold-up' problem.

Product repositioning

- 5.7.13 Some mergers of producers of differentiated products may result in the merged firm and its rivals repositioning (or 'rebranding') their products after the merger.⁷⁶ The merger firms may seek to reduce the cannibalisation between the merger firms' products by increasing the differentiation between them. Their rivals may then reposition their products between those of the merger firms. If so, post-merger product repositioning increases variety.
- 5.7.14 The overall effect of product repositioning on rivalry is particularly difficult to establish because it will be determined by increased variety plus the net effect of product repositioning on prices. The net effect of product repositioning on prices may be positive or negative.⁷⁷

■ *Demand-side efficiencies*

- 5.7.15 Demand-side efficiencies arise if the attractiveness to customers of the merged firm's products increases as a result of the merger. Common examples of demand-side efficiencies include:
- network effects;
 - pricing effects; and
 - 'one-stop shopping'.

Network effects

- 5.7.16 As noted in paragraphs 5.2.20 and 5.8.6, network effects, whether direct or indirect, arise when services are provided over a network or through a platform, where customers value the network or platform more highly when it is used by a greater number of other customers. Where there are direct network effects (ie within one group of customers), a merger may improve the competitive offering to all customers. Where network effects are indirect and involve two distinct

⁷⁶ See, for example, *Completed acquisition by Global Radio UK Limited of GCap Media plc*, OFT, August 2008.

⁷⁷ Product repositioning may reduce the substitutability between the merging products, mitigating post-merger price increases; but it may also soften price competition generally if product varieties 'spread out'.

groups of customers, a merger may improve the competitive offering to some customers but make it worse for others.

Pricing effects

5.7.17 Demand-side efficiencies may arise in a conglomerate merger when the merger firms’ products are complements, so that lowering the price of one product increases demand for it and for other products that are used with it. Bringing products that are complements under common ownership may allow the merged firm to obtain the positive effect of a fall in the price of one on sales of the others. Achieving this effect through a merger may result in lower prices for all products in the bundle, because it may become profit-enhancing for the firm which sells all the complements to sell them at a lower combined price than the sum the customer would have paid to assemble the same package from different suppliers before the merger.⁷⁸

‘One-stop shopping’

5.7.18 An additional demand-side efficiency may arise when the merger firms’ products are not substitutes and customers may have a stronger incentive to buy a range of products from a single supplier. This could be, for example, because purchasing from a single supplier reduces transaction costs or, where products are complementary, ensures improved product compatibility or quality assurance. Sometimes called ‘one-stop shopping’, this is an economy of scope in the purchase rather than in the production of goods.

■ **Section 5.8: Barriers to entry and expansion**

5.8.1 Any analysis of a possible SLC includes consideration of the responses of others (eg rivals, potential rivals and customers) to the merger. In the longer term competition in the market may also be affected as new firms enter, or the merged firm’s rivals take actions enhancing their ability to compete against the merged firm. Examples include:

- investment in new capacity, or conversion of existing capacity to a new use;
- entry using new technology enabling new production methods;
- investments in marketing and product design to reposition existing brands so that they compete more with those of the merged firm;
- sponsorship by customers of a new entrant with guarantees of business; and
- investment in capacity by customers to make their own input so that they no longer need to buy from the merged firm.

All of these actions can mitigate the initial effect of the merger on competition, and in some cases may mean that there is no SLC.

5.8.2 Most of this section deals with the consideration of actual entry, or of some other action by rivals that affects their ability to compete against the merged firm (for

.....
78 These efficiencies are known as Cournot effects.

convenience referred to as entry or expansion). But, in some cases, the fear of entry might deter the merged firm from exploiting any market power resulting from the merger. In such cases the Authorities need not expect that entry would actually take place. However, the Authorities consider this circumstance to be rare; it is discussed in paragraphs 5.8.14 and 5.8.15.

5.8.3 In assessing whether entry or expansion might prevent an SLC, the Authorities will consider whether such entry or expansion would be:

- (a) timely;
- (b) likely; and
- (c) sufficient.

5.8.4 Potential (or actual) competitors may encounter barriers which adversely affect the timeliness, likelihood and sufficiency of their ability to enter (or expand in) the market. Barriers to entry are thus specific features of the market that give incumbent firms advantages over potential competitors. Where entry barriers are low, the merged firm is more likely to be constrained by entry; conversely, this is less likely where barriers are high. The strength of any given set of barriers to entry or expansion will to some extent depend on conditions in the market, such as a growing level of demand.

■ *Types of barriers to entry and expansion*

5.8.5 The four broad categories of barriers to entry or expansion are:

- Absolute advantages for current market players—including:
 - legal advantages, such as government regulations that limit the number of market participants (eg restrictions on the number of licences granted), and tariff and non-tariff trade barriers; and
 - technical advantages, such as preferential access to essential facilities or intellectual property rights,⁷⁹ which make it difficult for any new entrant to compete effectively.
- Intrinsic/structural advantages—arising from the technology, production methods or other factors necessary to establish an effective presence in the market (eg initial set-up costs, costs associated with investment in specific assets, research and advertising). Such costs are more likely to deter entry or expansion where a significant proportion of them are sunk, ie the costs cannot be recovered when exiting from the market.
- Economies of scale—which arise where average costs fall as the level of output rises.⁸⁰ They may prevent small-scale entry from acting as an effective competitive constraint in the market. Further, in the presence of economies

79 For a case in which access to protected data was cited as a barrier to entry, see *Nufarm/A H Marks*, CC, February 2009, paragraph 6.83.

80 The Authorities note that economies of scale may exist only over a limited range of output, and may be exhausted past a certain level of output.

of scale large-scale entry or expansion will generally be successful only if it expands the total market significantly, or substantially replaces one or more existing firm; and if the entrant can afford the risk that such investment will involve, especially in terms of sunk costs.

- Strategic advantages—which arise where incumbent firms have advantages over new entrants because of their established position (sometimes called ‘first-mover advantages’). These advantages can flow, for example, from the experience and reputation which incumbents have built up, or from the loyalty which they have attracted from customers and suppliers. Incumbent firms may sometimes behave strategically in responding to the threat of entry, for example by lowering prices or by investing in additional capacity or additional brands to deter entry.

5.8.6 Strategic advantages may be particularly acute in markets with direct or indirect network effects (see paragraphs 5.2.20 and 5.7.16). Direct or indirect network effects can make the market prone to ‘tipping’. Tipping arises where one firm, or technology, gains an advantage in the market and the balance of power in the market moves in its direction, leaving it as the unassailable leader. Tipping may create switching costs for existing customers, and often means that in the presence of one network it may not be possible for a network configured in a different way to be viable. In markets characterised by network effects, a likely entrant will need to take the risk of developing new infrastructure but may not succeed in creating the necessary demand to make this profitable.

5.8.7 In assessing tipping, the Authorities will consider whether or not customers would be willing to switch to a new supplier. Customers’ willingness will depend on the costs and benefits to them of switching. To assess these, the Authorities may take into account: the (actual or perceived) cost of switching, brand loyalty, the length of existing contracts and the closeness of relationships between suppliers and customers. In addition, customers may be willing to sponsor and/or facilitate new entry.

■ *Likelihood of entry or expansion*

5.8.8 The Authorities will consider not only the scale of any barriers to entry and/or expansion that may impact on the likelihood of entry or expansion but also whether firms have the ability and incentive to enter the market (or the intent to do so). For example, in a market characterised by low barriers to entry and/or expansion, entrants may nevertheless be discouraged from entry by the small size of the market, or the credible threat of retaliation by incumbents (whether in the same market as the merged firm or another where that new entrant is already present).

5.8.9 In assessing the likelihood of post-merger entry or expansion, the Authorities will consider whether entry or expansion is likely to take place if the entrant expects post-entry prices to be at pre-merger levels. This is because, if prices were to rise post-merger, only an entrant (or an incumbent) who would find it profitable to

operate (or add capacity) in the market at pre-merger prices is likely to enter (or expand) and return prices to pre-merger levels.

■ *Scope of entry or expansion*

5.8.10 To be considered a competitive constraint, entry or expansion should be of sufficient scope to deter or defeat any attempt by the merged firm to exploit any lessening of competition resulting from the merger. Small-scale entry, when the market share of the entrant is small compared with that of the merged firm, may nonetheless be sufficient to prevent an SLC for undifferentiated goods where there are no barriers to further expansion. By contrast, small-scale entry by a producer of differentiated goods may be insufficient, even when the entry may be the basis for later expansion. For example, entry into some market niche may be possible, but the niche product may not necessarily compete strongly with other products in the overall market and so may not constrain incumbents effectively.

■ *Timeliness of entry or expansion*

5.8.11 Entry and/or expansion must also be expected to be sufficiently timely and sustained to constrain the merged firm. The Authorities may consider entry or expansion within less than two years as timely, but this is assessed on a case-by-case basis, depending on the characteristics and dynamics of the market, as well as on the specific capabilities of potential entrants.

■ *Assessment of entry or expansion*

5.8.12 In assessing whether entry and/or expansion might act as an effective competitive constraint on the merged firm, the Authorities will typically gather information on several relevant factors:

- the history of past entry or expansion; this will include a consideration of the costs of such entry, how long any entrants traded in the market and the effects that entry or expansion had on competition in the market—in particular, whether past entry or expansion modified the pattern of behaviour and competition;⁸¹
- evidence of planned entry or expansion by third parties;
- direct observations, or statistical information, on barriers to entry, expansion and exit;
- the costs involved in entry or expansion and in operating at the minimum efficient scale necessary to achieve a reasonably competitive level of costs (and consequently to avoid any cost disadvantage from operating below the minimum efficient scale);

81 See *Nufarm/A H Marks*, CC, February 2009, paragraph 6.84

- the period of time over which costs of entry or expansion might be recovered so as to assess whether entry or expansion will be profitable (at pre-merger prices);
- the existence of long-term contracts;
- the cost of exiting from the market (so as to establish if the costs of entering the market are so large and sunk that they cannot be recovered upon exit);
- the potential effect of technological change and innovation on barriers to entry or expansion;
- the ability and incentive of customers to sponsor entry or expansion in the relevant market(s);
- the possibility of imports or supply-side reactions to the extent that these have not already been taken into account in market definition, for example because they would not occur quickly enough to affect the market definition; and
- the likely response to entry or expansion by incumbent firms.

5.8.13 The Authorities will also consider how the merger may affect the likelihood of new entry or expansion. The merger may increase barriers to entry and/or expansion by, for example, allowing the merged firm to benefit from positive network effects, strengthening its incumbency advantage in a network market (see paragraphs 5.2.20, 5.8.6 and 5.7.16). A larger merged firm might also be perceived to increase the risk involved in entry or expansion by potential new entrants or existing competitors since the larger the firm, the more it might be expected to defend its position in the market.

■ *Constraints from potential entry*

5.8.14 In some cases, the merged firm may not be able to exploit any loss of competition arising from the merger because of the threat of potential entry. Potential entry may be a constraint on the merged firm if entry would be so quick and costless that an entrant could profitably come into the market to exploit an opportunity afforded by high prices even if the merged firm quickly responded to the entry by lowering its prices. (For a discussion in the context of unilateral effects, see paragraphs 5.4.13 to 5.4.18.)

5.8.15 A constraint from potential entry is more likely when entry can take place without the entrant incurring any substantial sunk costs, and if it can happen within a year, although the Authorities' assessment in any particular case will take account of the particular features of the market in question (see paragraph 5.8.11). A constraint from potential entry may arise even though there may be no expectation on the part of the Authorities that entry would actually occur.

■ **Section 5.9: Countervailing buyer power**

5.9.1 In some circumstances, an individual customer may be able to use its negotiating strength to limit the ability of a merged firm to raise prices. The

Authorities refer to this as countervailing buyer power. The existence of countervailing buyer power will be a factor in making an SLC finding less likely, in contrast to the scenarios discussed in paragraphs 5.4.19 and 5.4.21, where buyer power might contribute to an SLC finding. If all customers of the merged firm possess countervailing buyer power post-merger, then an SLC is unlikely to arise. However, often only some—not all—customers of the merged firm possess countervailing buyer power. In such cases, the Authorities assess the extent to which the countervailing buyer power of these customers may be relied upon to protect all customers.⁸²

- 5.9.2 Buyer power can be generated by different factors. An individual customer's negotiating position will be stronger if it can easily switch its demand away from the supplier, or where it can otherwise constrain the behaviour of the supplier.
- 5.9.3 Typically the ability to switch away from a supplier will be stronger if there are several alternative suppliers to which the customer can credibly switch, or the customer has the ability to sponsor new entry or enter the supplier's market itself by vertical integration. Where customers have no choice but to take a supplier's products, they may nonetheless be able to constrain prices by imposing costs on the supplier. For example, customers may be able to refuse to buy other products produced by the supplier, or, in the case of a retailer, position the supplier's products in less eye-catching parts of the store.
- 5.9.4 Even where the market is characterised by customers who are larger than the suppliers, it does not necessarily follow that there will be countervailing buyer power. The Authorities will assess whether and to what extent the merger is likely to reduce the customer's ability and incentive to pursue credibly any of the strategies set out above. It is possible, for example, that a merger may reduce a customer's ability to switch or even to sponsor new entry and, if this reduction adversely affects the negotiating position of a customer significantly, that customer's buyer power will not be sufficient to be countervailing.
- 5.9.5 Where a supplier is engaged in bilateral negotiations with each of its customers, the relative bargaining strength of the supplier and each of its customers is determined by their mutual dependency. In such situations it may be easier for large customers to threaten to sponsor new entry or vertically integrate than it would be for smaller customers who could not commit a sufficiently large volume of purchases to make either viable. Conversely, small buyers may be in a better position to switch suppliers because of the lower volume of their purchases.
- 5.9.6 The extent to which the buyer power of one customer, or group of customers, can constrain the merged firm's prices to all its customers (sometimes referred to as the 'umbrella effect') will depend on the market concerned. Where individual negotiations are prevalent, the buyer power possessed by any one customer will

82 See, for example, *Heinz/HP Foods Group*, CC, March 2006, *Macaw (Holdings) Ltd/Cott Beverages Ltd*, CC, April 2006, and *Nufarm/A H Marks*, CC, February 2009.

not typically protect other customers from any adverse effect that might arise from the merger.⁸³

- 5.9.7 In cases where there are no bilateral negotiations between suppliers and customers, and the market price of the input is transparent to all suppliers and customers, buyer power may arise simply because of a buyer's size. In these cases, the buyer power of one or more customers may act to protect other customers with less or no buyer power by preventing a rise in the price ultimately paid by all customers.
- 5.9.8 For countervailing buyer power to prevent an SLC, it is not sufficient that it merely existed before the merger. It must also remain effective following the merger. To assess this, the Authorities will consider the impact of the merger on any countervailing buyer power.

.....
 83 But there may be occasions when it does so, for example if increases in productive capacity in the market through buyer-sponsored entry benefit all customers.

Part 6

Public interest cases

In mergers raising certain public interest considerations, the Secretary of State for Business, Innovation and Skills may intervene. Such intervention enables the Secretary of State to assume responsibility for determining whether or not to refer a merger to the CC and to take the ultimate decision in respect of mergers when defined public interest considerations are potentially relevant. Part 6 of the guidelines outlines the three types of public interest cases, describes how such cases are conducted and discusses the decisions falling to the CC and the Secretary of State.⁸⁴

■ Section 6.1: Types of cases

6.1.1 There are three categories of public interest cases:

- public interest;
- special public interest; and
- in respect of mergers with a ‘Community’ dimension, cases raising legitimate interests.

6.1.2 These categories have in common the involvement of the Secretary of State for Business, Innovation and Skills, who initiates them by the service of an intervention notice. However, the procedures and issues are distinct and the roles of the Authorities also vary compared with merger cases that do not raise public interest issues (general mergers). The effects on competition of the merger (ie the SLC test) are only considered by the Authorities in the first category of cases listed above (ie public interest cases). In the second category, competition issues are not considered. In the third category, the competition issues are considered by the European Commission, with the Authorities and Secretary of State considering only the public interest considerations.

■ Public interest cases

6.1.3 The Act enables the Secretary of State to intervene when he or she considers that one or more of the public interest considerations specified in the Act

84 See OFT, *Mergers—Jurisdictional and procedural guidance* (Part 9) and DTI, *Enterprise Act 2002: Public Interest Intervention in Media Mergers*.

is or may be relevant to the consideration of a merger. The public interest consideration may be specified at the time of intervention or may be one which the Secretary of State considers ought to be specified (and if so, the Secretary of State must then take appropriate action for it to become specified—see paragraph 6.1.5).

6.1.4 Presently, the specified public interest considerations are:⁸⁵

- national security (including public security);⁸⁶
- the interests of maintaining the stability of the UK financial system;⁸⁷ and
- the need for:
 - accurate presentation of news in newspapers;⁸⁸
 - free expression of opinion in newspapers;⁸⁹
 - a sufficient plurality of views in newspapers in each market for newspapers in the UK or a part of the UK to the extent that it is reasonable and practicable;⁹⁰
 - there to be a sufficient plurality of persons with control of the media enterprises serving every different audience in the UK, or in a particular area or locality of the UK (the ‘plurality test’—see paragraph 6.1.14);⁹¹
 - the availability throughout the UK of a wide range of broadcasting which (taken as a whole) is both of high quality and calculated to appeal to a wide variety of tastes and interests;⁹² and
 - persons carrying on media enterprises, and for those with control of such enterprises, to have a genuine commitment to the attainment in relation to broadcasting of the standards and objectives set out in section 319 of the Communications Act 2003.⁹³

6.1.5 The Act permits the Secretary of State to modify this list of public interest considerations, to specify a new consideration or to remove or amend an existing consideration.

85 Section 58. The first public interest case relating to the media under the Act arose in May 2007 when the Secretary of State referred to the CC BSKyB’s acquisition of a 17.9 per cent stake in ITV, *BSkyB/ITV*, CC, December 2007.

86 Section 58(1) and (2).

87 Section 58(2D). On 18 September 2008, the Secretary of State had issued an intervention notice specifying this consideration in the context of the proposed merger between Lloyds TSB Group plc and HBOS plc. On 31 October 2008, the Secretary of State exercised his discretion not to refer the merger to the CC on the basis that the merger would result in significant benefits to the public interest as it related to ensuring the stability of the UK financial system and that these benefits outweighed the potential for the merger to result in anti-competitive outcomes identified by the OFT. For the text of the decision, see www.berr.gov.uk/files/file48745.pdf.

88 Section 58(2A)(a).

89 Section 58(2A)(b).

90 Section 58(2B).

91 Section 58(2C)(a).

92 Section 58(2C)(b).

93 Section 58(2C)(c).

■ *Special public interest cases*

- 6.1.6 This category of cases concerns mergers which may be referred to the CC on public interest grounds when the normal jurisdictional thresholds relating to turnover or share of supply in the Act are not satisfied. The category comprises:
- certain media mergers (see paragraph 6.1.8); and
 - mergers involving government contractors (see paragraph 6.1.9).
- 6.1.7 To qualify as a ‘special merger situation’, the merger, although not meeting either the turnover or the share of supply thresholds (see paragraphs 3.3.1 and 3.3.2 and 3.3.3 to 3.3.5, respectively), falls within the meaning of a relevant merger situation but for it not satisfying either threshold.⁹⁴
- 6.1.8 In respect of media mergers, a special merger situation is created if either:⁹⁵
- (a) in relation to the supply of newspapers of any description, at least one-quarter of all the newspapers of that description which were supplied in the UK, or in a substantial part of it, were supplied by the person or persons by whom one of the enterprises concerned was carried on; or
 - (b) in relation to the provision of broadcasting of any description, at least one-quarter of all broadcasting of that description provided in the UK, or in a substantial part of it, was provided by the person or persons by whom one of the enterprises concerned was carried on.
- 6.1.9 In respect of mergers involving a government contractor, a special merger situation is created if:⁹⁶
- (a) at least one of the enterprises concerned was carried on in the UK or in a substantial part of it, by, or under the control of, a body corporate incorporated in the UK; and
 - (b) a person carrying on one or more of the enterprises concerned was a relevant government contractor.
- 6.1.10 If either of these types of special merger situation exists, and the Secretary of State intervenes, the national security or media merger considerations as they apply to public interest cases may be considered.⁹⁷ Neither type of case involves a competition assessment, the assessment made being confined to the relevant public interest consideration.

94 Section 59(3)(a). Section 59(5) applies sections 23 to 32 with adjustments.

95 See section 59(3C) and (3D) and section 59A.

96 See section 59(3B) and (8).

97 Section 60. See paragraph 6.1.4.

■ **Mergers with a ‘Community dimension’ (‘legitimate interest’ cases)**

6.1.11 In cases where a merger falls to be examined under the ECMR,⁹⁸ the Act makes provision for the Secretary of State to intervene when the Secretary of State believes that one or more public interest considerations is relevant⁹⁹ (since the ECMR permits member states to take action to protect ‘legitimate interests’).¹⁰⁰ The public interest grounds on which the Secretary of State may intervene are limited to those listed in section 58 (other than the interest of maintaining the stability of the UK financial system, which is expressly stated not to be a consideration for the purposes of intervention under the ECMR¹⁰¹).

6.1.12 Notwithstanding that the Secretary of State has intervened, the competition assessment of the merger in this category of case remains the responsibility of the European Commission.

■ **Media mergers**

6.1.13 Detailed guidance on the process and the Secretary of State’s approach in media merger public interest intervention cases is available on the [BIS website](#) (see Part 7).

6.1.14 The CC has set out its approach to the ‘plurality test’ (see paragraph 6.1.4).¹⁰² It does not regard the test as simply an exercise in counting the number of controllers. The CC will have regard to both the range and the number of persons with control of media enterprises. The CC will also have regard to the degree of control exercised by one enterprise over another, including whether the extent and level of control are increased as a result of the merger. Where control is less than complete, the CC will consider whether in practice it would enable the controlling enterprise to dominate the policy and the output of the controlled enterprise. Where appropriate, the CC may distinguish between the plurality of persons with control of media enterprises and the implications of that plurality for the range of information and views made available to audiences.¹⁰³

■ **Section 6.2: The conduct of public interest cases**

6.2.1 The three categories of public interest cases are the exceptions in the UK merger regime that involve the Secretary of State. They have in common the issuing of a notice by the Secretary of State.¹⁰⁴ The effect of such a notice is to require the OFT to investigate the merger and provide a report. Further information about the role of the OFT and the content of the OFT’s report, and the Secretary of State’s consideration of the OFT’s advice, including whether or not to make a reference

98 Articles 1(2) and 1(3) ECMR. See also footnote 8: the ECMR remains the official title of the regulation and its terminology is used throughout this publication.

99 Sections 67 and 68.

100 Article 21(4) ECMR.

101 Article 2 SI 2008/2645.

102 *BSkyB/ITV*, CC, December 2007.

103 The CC’s approach to the ‘plurality test’ was upheld in January 2010 by the Court of Appeal in its judgment in *BSkyB and Virgin Media v. Competition Commission and BERR*, <http://www.bailii.org/ew/cases/EWCA/Civ/2010/2.html>.

104 Public Interest Intervention Notice (PIIN) in public interest cases, Special Public Interest Intervention Notice (SPIIN) in special public interest cases and European Intervention Notice in cases raising legitimate interests (EIN).

to the CC, can be found in the OFT's *Mergers—jurisdictional and procedural guidance (OFT527)*.

- 6.2.2 In cases in which the Secretary of State has intervened on media public interest grounds, Ofcom, the regulator and competition authority for the UK communication industries, will advise the Secretary of State on the public interest aspects of the case.¹⁰⁵

■ *Reference decisions by the Secretary of State*

- 6.2.3 In all three cases, a reference may be made by the Secretary of State to the CC after he or she has received a report from the OFT. The Secretary of State is required to accept the OFT's findings on whether there is a 'relevant merger situation' and, where appropriate, competition matters including the description of undertakings the OFT considers are appropriate in lieu of a reference.¹⁰⁶
- 6.2.4 Not all public interest cases in which the Secretary of State has served an intervention notice will result in a reference to the CC being made under the public interest provisions. This may be because the Secretary of State has accepted undertakings in lieu of a reference,¹⁰⁷ or other circumstances.¹⁰⁸ Additionally, when a public interest intervention notice has been served, if the Secretary of State decides that there is no relevant public interest consideration, the OFT is required to deal with the matter as if it is a general merger (this may entail making a reference to the CC under sections 22 or 33).¹⁰⁹

Public interest cases

- 6.2.5 There are several circumstances in which a reference is possible in public interest cases, but in all of them the Secretary of State must believe that it is or may be the case that a relevant merger situation has been created or will be created and that the merger operates, or may be expected to operate, against the public interest.¹¹⁰ The belief that the merger is against the public interest can be formed taking into account only the relevant public interest consideration or taking into account both that consideration and any belief that the merger situation results or is expected to result in an SLC.

Special public interest cases

- 6.2.6 The Secretary of State may make a reference if he or she believes that it is or may be the case that a special merger situation has been created or that arrangements are in progress or contemplation that will result in such a situation, and that one or more of the relevant public interest considerations is relevant

.....
105 Section 44A (public interest), section 61A (special public interest) and Article 4A SI 2003/1592 (legitimate interest), as amended by SI 2003/3180.

106 Section 46(2) (public interest), section 62(5) (special public interest) and Article 5(5) SI 2003/1592 (legitimate interest).

107 Schedule 7, paragraph 3 (public interest and special public interest) and Schedule 2 SI 2003/1592 (legitimate interest).

108 Section 46 (public interest), section 62 (special public interest) and Article 5 SI 2003/1592 (legitimate interest).

109 Section 56.

110 Section 45.

to the merger and operates, or may be expected to operate, against the public interest.¹¹¹

Mergers with a ‘Community dimension’ (‘legitimate interest’ cases)

6.2.7 The Secretary of State may make a reference if he or she believes that it is or may be the case that a ‘European relevant merger situation’ has been created or that arrangements are in progress or contemplation that will result in such a situation and that one or more of the relevant public interest considerations is relevant to the merger and operates or may be expected to operate against the public interest.¹¹²

■ **Section 6.3: Decisions for the CC and the Secretary of State**

■ *Questions for the CC*

Public interest cases

6.3.1 The circumstances in which a case is referred and which raise public interest considerations can vary and, depending upon the circumstances, the questions that the CC must answer similarly vary.¹¹³ In all circumstances the CC will consider whether:

- (a) a relevant merger situation has been created or arrangements are in progress or contemplation that will lead to a relevant merger situation; and, if so,
- (b) whether the creation of the relevant merger situation operates, or may be expected to operate, against the public interest (the public interest test).

6.3.2 However, the factors that the CC must take into account when answering the public interest test vary according to the reference. Some references require the CC to consider the separate question of whether the creation of the relevant merger situation may be expected to result in an SLC. In these cases, the CC must answer the public interest test taking account of any SLC and the relevant public interest consideration. In other circumstances, the reference will not require the CC to apply the SLC test and the public interest test is answered taking account only of the relevant public interest consideration.

6.3.3 If the CC decides that the merger is against the public interest, it must then answer questions relating to remedies:

- (a) whether action should be taken by the Secretary of State under the Act to remedy the adverse public interest effects;
- (b) whether the CC should recommend the taking of other action by the Secretary of State or others for such purposes; and, in either case,
- (c) what the action should be.

.....
111 Section 62.

112 Article 5, SI 2003/1592.

113 Section 47.

- 6.3.4 Additionally, if the CC has decided that there is or will be an SLC resulting from the merger, it must answer the same remedies questions that it answers in general mergers (assuming that the CC will be required to take action). The CC is required to proceed as if the case was a general merger if the Secretary of State, upon receipt of the CC's report, decides not to make a finding.¹¹⁴
- 6.3.5 In deciding the questions mentioned in paragraphs 6.3.3 and 6.3.4, the CC must have, in particular, regard to the need to achieve as comprehensive a solution as is reasonable and practicable to the adverse effects to the public interest; or, if appropriate, to the SLC and any adverse effects resulting from it.¹¹⁵ If it has decided that there is or will be an SLC, the CC may also have regard to the effect of any action on any relevant customer benefits.¹¹⁶
- 6.3.6 In these references, when considering whether there is a relevant merger situation and, if appropriate, applying the SLC test, the CC will have regard to the various factors explained in Parts 2 to 5 of these guidelines.
- 6.3.7 When reporting on both the SLC question and a relevant public interest question, the CC will deal with each question separately. The CC will then consider whether, overall, the merger may be expected to operate against the public interest. Any anti-competitive outcome shall be treated as being adverse to the public interest unless it is justified by one or more than one public interest consideration which is relevant.¹¹⁷

Special public interest cases

- 6.3.8 In special merger cases raising public interest considerations, the CC must answer the following questions:
- (a) whether a special merger situation has been created (or arrangements for such a situation are in progress or contemplation); and, if so,
 - (b) whether the creation of that situation operates (or may be expected to operate) against the public interest.¹¹⁸
- 6.3.9 If the CC concludes that the merger operates against the public interest, it must also consider whether remedial action is appropriate (see paragraph 6.3.3).
- 6.3.10 In this case, the CC will not apply the SLC test but will decide the public interest question taking into account only the consideration mentioned in the reference.

Mergers with a 'Community dimension' ('legitimate interest' cases)

- 6.3.11 In these references, the CC must decide:¹¹⁹

114 Section 56(6).

115 Section 47(9).

116 Section 47(10). For the meaning of 'relevant customer benefits', see paragraph 5.7.3 and the CC's *Merger Remedies: Competition Commission Guidelines*, CC8 November 2008, paragraphs 1.14 to 1.20.

117 Section 45(6).

118 Section 63.

119 Article 6, SI 2003/1592.

- (a) whether a ‘European relevant merger situation’ is created or whether arrangements are in progress or contemplation; and, if so,
- (b) whether the creation of the ‘European relevant merger situation’ operates, or may be expected to operate, against the public interest, taking into account only the public interest consideration mentioned in the reference.

6.3.12 If the CC decides that the merger situation is expected to operate against the public interest, it must also answer remedy questions similar to those applying to public interest and special public interest cases (see paragraph 6.3.3).

■ **Decisions for the Secretary of State**

6.3.13 On receipt of the CC’s report, the Secretary of State has 30 working days in which to make a decision on the questions the CC had to decide. In public interest cases, the Secretary of State must accept the CC’s decision on whether there is a relevant merger situation and whether that merger results in an SLC.¹²⁰ In special public interest cases, the Secretary of State must accept the CC’s decision on whether there is a special merger situation.¹²¹ In mergers with a ‘Community dimension’, the Secretary of State must accept the CC’s decision on whether there is a ‘European relevant merger situation’.¹²²

6.3.14 In all three categories of cases, when deciding whether the merger is against the public interest, the Secretary of State is not bound by the CC’s views on the public interest test, having discretion in relation to the public interest consideration. The Secretary of State also has discretion when considering whether and which remedies are necessary to address the adverse public interest effects.¹²³ If the Secretary of State decides that the merger is against the public interest, he or she has the power to take remedial action.¹²⁴ In public interest cases, if the Secretary of State decides that the public interest issue is not relevant, the CC then decides how to remedy any competition issue identified.¹²⁵

.....
120 Section 54(7).

121 Section 66(4).

122 Article 12, SI 2003/1592.

123 Section 54 (public interest), section 66 (special public interest) and Article 12 SI 2003/1592 (legitimate interest).

124 Section 55 (public interest), section 66 (special public interest) and Article 12 SI 2003/1592 (legitimate interest).

125 Section 56.

Part 7

Publications relevant to the UK merger regime

Competition Commission publications

www.competition-commission.org.uk

CC1 Competition Commission Rules of Procedure

CC4 General Advice and Information

CC5 Statement of Policy on Penalties

CC6 Chairman's Guidance to Groups

*CC7 Chairman's Guidance on Disclosure of Information in
Merger and Market Inquiries*

CC8 Merger Remedies: Competition Commission Guidelines

CC9 Water Merger References: Competition Commission Guidelines

*CC12 Disclosure of Information by the Competition Commission
to other public bodies*

Competition Commission Annual Report and Accounts

Forthcoming: Mergers—procedural guidance

OFT publications

www.offt.gov.uk

OFT527 Mergers—jurisdictional and procedural guidance

*OFT1122 Mergers—exceptions to the duty to refer and undertakings in lieu of
reference (to be published)*

Competition Appeal Tribunal publications

www.catribunal.org.uk

Competition Appeal Tribunal Rules

Department for Business, Innovation and Skills publications

<http://www.bis.gov.uk/policies/business-law/competition-matters/mergers>

DTI, Enterprise Act 2002: Public Interest Intervention in Media Mergers

CC2 (Revised) OFT1254

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