Clifford Chance

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RESPONSE OF CLIFFORD CHANCE LLP TO THE MERGER EFFICIENCIES REVIEW: CALL FOR EVIDENCE OF THE COMPETITION AND MARKETS AUTHORITY

Clifford Chance LLP welcomes the opportunity to respond to the Merger Efficiencies Review: Call for Evidence of the Competition and Markets Authority. Our comments below are informed by our experience advising on merger control proceedings in the UK and other jurisdictions. However, the comments in this response do not necessarily represent the views of our clients.

1. IMPROVEMENTS TO THE GUIDANCE

1.1 We are pleased to note that the Draft Guidance addresses a number of the concerns we raised in our response to the CMA's earlier Call for Evidence on merger efficiencies. In particular, we welcome:

1.1.1 the significantly expanded treatment of the types of efficiency that can arise, including a dedicated section on dynamic efficiencies and innovation (paragraphs 17 and 29 of the Draft Guidance);

1.1.2 the more nuanced approach to timeliness, which explicitly acknowledges that different efficiency types may materialise over different timeframes — including several years for dynamic efficiencies — and that account will be taken of market-specific investment and innovation cycles (paragraphs 20-22);

1.1.3 the recognition that uncertainty about innovation outcomes does not automatically preclude an efficiency from being taken into account, and that the CMA may assess whether a merger strengthens the process of dynamic competition rather than requiring proof of a specific outcome (paragraph 29);

1.1.4 the acknowledgment that precise quantification is not necessary and will often not be possible (paragraph 28);

1.1.5 the clarification that the submission of evidence on efficiencies does not imply acceptance of the existence of an SLC (paragraph 42); and

1.1.6 the call for early engagement, and the explicit recognition that the CMA will provide feedback on submissions and guidance on further evidence during pre-notification and Phase 1 (paragraph 40).

1.2 Notwithstanding these improvements, there remain a number of concerns that, we submit, the Draft Guidance need to address if they are effectively to allow for pro-competitive efficiencies, in the interests of consumers and the economy - and, in some cases, the specific wording currently used is liable to discourage parties from bringing forward what are genuinely pro-competitive efficiency arguments. Our detailed comments are set out below. Where appropriate, we have suggested specific amendments to the text.

2. **FIXED COSTS AND THE INCENTIVE TO COMPETE**

2.1 Paragraph 16 of the Draft Guidance states that the CMA "will generally view reductions in the merger firms' marginal or variable costs as being more likely to result in an incentive to reduce price or make short-run improvements in quality than reductions in fixed costs", but that "in some cases, fixed cost savings may impact the ability or incentives of the merged firm to innovate or invest, for example by raising the expected returns on investment". This is an improvement on the current MAGs. However, the formulation still treats fixed cost savings as a secondary category of efficiency, less likely than variable cost reductions to attract weight in the CMA's assessment.

2.2 This framing does not adequately reflect competitive dynamics in capital-intensive industries, technology markets, and other sectors where investment capacity is a key parameter of competition - sectors which, perhaps not coincidentally, are also key drivers of economic growth and prosperity in the UK. The CMA's own decision in *Vodafone/Three* — cleared in Phase 2 on the basis of rivalry-enhancing efficiencies — illustrates that reductions in the incremental unit cost of adding capacity, which would conventionally be treated as a fixed cost saving, can directly incentivise investment that enhances rivalry in a fundamental way. Where a merger enables the merged entity to build capacity, deploy infrastructure, or undertake R&D investment that would not otherwise be commercially viable, the competitive impact of those fixed cost savings can be at least as significant as variable cost reductions, and in dynamic industries, considerably more so.

2.3 We suggest that paragraph 16 be amended to acknowledge that the distinction between fixed and variable costs is context-dependent and, in particular, that in capital-intensive or technology-intensive markets, fixed cost savings that enable investment or capacity expansion should be given equivalent weight to variable cost reductions when assessing the incentive to compete. In addition, in sectors with long investment cycles, fixed cost savings may translate into competitive benefits more directly than marginal cost reductions, and the guidance should make clear that the CMA will assess the relevant cost category by reference to the specific competitive dynamics of the market in question.

2.4 We propose the following addition to paragraph 16:

> "*In capital-intensive, infrastructure or technology markets, the distinction between fixed and marginal costs may be less material to the competitive impact of the efficiency.*

Where fixed cost savings enable the merged entity to invest in capacity, infrastructure or R&D that would not otherwise have been commercially viable, and where that investment would directly enhance the merged entity's ability or incentive to compete, the CMA will give such efficiencies equivalent weight to variable cost reductions. The CMA will assess the competitive significance of cost savings by reference to the specific economics and competitive dynamics of the relevant market."

3. **TIMELINESS AND THE TREATMENT OF TIME-LIMITED SLCS**

3.1 We welcome the significantly improved treatment of timeliness in paragraphs 20-22 of the Draft Guidance, including the explicit acknowledgment that dynamic efficiencies may not be fully realised for several years and that the CMA will have regard to investment and innovation cycles.

3.2 Paragraph 30 introduces the concept of a "time-limited SLC", recognising that a merger could lead to short-term harm before longer-term benefits are realised. However, the draft appears to assume that, in such cases, the CMA would always find an SLC and then consider whether remedies can address it. We suggest that the guidance should go further and make clear that, where the evidence establishes that longer-term benefits are likely to be of sufficient magnitude to outweigh the short-term harm — and where that harm is therefore not expected to persist or leave lasting competitive damage — the CMA may conclude that there is no SLC overall, rather than finding a time-limited SLC and then imposing remedies to manage it. If the CMA's response to a time-limited SLC is invariably to impose remedies — including price controls or behavioural commitments — this is likely to deter mergers that are net beneficial over their competitive lifetime.

4. **MERGER SPECIFICITY: THE ACCELERATION OF BENEFITS**

4.1 Paragraph 31 makes an important – and, in our view, materally detrimental - amendment to the existing guidance, by changing the word "would" to "could" in the statement that the CMA will assess whether efficiencies "could realistically be brought about by other means". This implies a move away from the assessment of merger specificity as a counterfactual exercise – *i.e.,* what is likely to happen in the absence of the merger – to a position that, where it is merely possible that efficiencies might be achieved in the absence of the merger, that would weigh against the merger. In our view, this single change raises the burden of proof for merger parties to such an extent as to undermine the stated purpose of the revised guidance: to promote pace, predictability, proportionality and engagement in relation to merger efficiencies. In addition, it would make it harder to predict when the CMA is likely to consider that a claimed efficiency is merger specific.

4.2 In our view, moving away from a counterfactual analysis is inconsistent with:

4.2.1 the applicable legal test. The test for specificity is ultimately one of causation - *i.e.*, whether efficiencies will be caused by the merger – and causation is assessed by reference to a counterfactual (as is the case, for example, when considering the failing firm defence);

4.2.2 the CMA's past practice, which has been to assess whether efficiencies "would be likely to be brought about by other means";[1] and

4.2.3 the remainder of the Draft Guidance, which accepts that efficiencies will be considered merger specific if they would not be feasible or commercially rational in the absence of the merger.

4.3 We therefore submit that the final guidance should state that the CMA will assess whether efficiencies "would be likely to be brought about by other means, in the absence of the merger".

4.4 In addition, paragraphs 31-33 do not address one particular issue that can arise in merger-specificity assessments. Where a benefit would be achievable in the counterfactual – for example, through organic investment or licensing – but the merger would bring that benefit about significantly earlier, the incremental benefit of accelerated delivery is merger-specific even if the ultimate benefit is not. The acceleration of benefits has real economic value: it may determine whether a technology reaches the market during a critical competitive window, whether a capacity expansion occurs before or after a rival establishes a dominant position, or whether a standard becomes established in a nascent market. We suggest that paragraph 33 be amended to recognise that "where benefits could in principle be achieved in the counterfactual but the merger accelerates their delivery by a significant period, the value attributable to that acceleration – including the competitive benefits arising during the intervening period – constitutes a merger-specific efficiency."

5. DYNAMIC EFFICIENCIES AND INNOVATION

5.1 We welcome the improved treatment of dynamic efficiencies in paragraphs 17 and 29. In particular, paragraph 29 explicitly acknowledges that there may be uncertainty about whether innovations will ultimately result in products or services being made available to customers, and that the CMA may consider whether a merger "is likely to strengthen the process of dynamic competition in a timely manner". This is a significant and helpful clarification.

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[1] See *Vodafone / CK Hutchison JV merger inquiry*, Final Report, paragraph 14.196

5.2 We suggest, however, that the guidance could be more effective in addressing how it will assess evidence of dynamic efficiencies in practice. The key difficulty with innovation-related efficiencies is not typically that the evidence is absent, but that it is qualitative and probabilistic in nature – involving R&D pipelines, technology roadmaps, product development strategies, and investment plans whose outcomes cannot be predicted with precision. While we recognise that the CMA's practice of placing the greatest evidentiary weight on materials generated in the ordinary course of business (paragraph 7) is appropriate, those materials are themselves unlikely to quantify innovation outcomes with the precision that the CMA would expect from, say, a synergy analysis of logistics cost savings.

5.3 We note that the CMA often identifies theory-of-harm concerns relating to dynamic competition – including the loss of pipeline products or the elimination of nascent competitive threats – on the basis of probabilistic evidence and qualitative analysis. The same standard of evidential inference should, in principle, apply to dynamic efficiency claims. The CMA should not require a higher degree of certainty in relation to the benefits of increased innovation effort than it accepts in relation to the harm of a reduction in innovation competition.

5.4 We therefore suggest that the Draft Guidance include an additional paragraph after paragraph 29, making clear the CMA's approach to evidence of dynamic efficiencies:

> *"In assessing dynamic efficiencies, the CMA will apply a consistent standard across the assessment of both competitive harms and competitive benefits arising from changes to the process of innovation or investment. Accordingly, where the merger firms can demonstrate that a merger will increase the merged entity's ability or incentive to innovate – for example, by combining complementary R&D capabilities, reducing the incremental cost of innovation investment, or improving the prospects of successful commercialisation – the CMA will assess this as an increase in the potential for beneficial innovation, applying appropriate discounting to reflect the probability and timing of successful outcomes. The CMA will consider a combination of quantitative and qualitative evidence, as appropriate to the nature of the claimed efficiency and the industry context."*

5.5 More broadly, paragraph 8 of the Draft Guidance usefully recognises that parties may supplement internal documents with bespoke analysis, and that economic modelling should "reflect commercial realities and be grounded in evidenced assumptions and parameters". We suggest that the guidance also makes clear that well-constructed qualitative evidence — such as expert testimony from industry specialists, evidence from sector regulators, or comparable evidence from analogous mergers in adjacent jurisdictions — can be sufficient to establish the likelihood of dynamic efficiencies, even in the absence of a formal quantitative model. The level of evidential precision required should be proportionate to the nature and scale of the claimed efficiency.

6. PHASE 1 STANDARD

6.1 Paragraph 12 provides that at Phase 1, "the evidence must be sufficient to satisfy the CMA within the time available in an initial investigation that rivalry-enhancing efficiencies would prevent a realistic prospect of an SLC". We note that the "realistic prospect" test is, by design, a low threshold — representing a prospect that is merely greater than fanciful. Requiring efficiencies to be capable of preventing any realistic prospect of an SLC, even one that has a very low probability of materialising, is a very high bar and is likely to deter parties from raising efficiency arguments at Phase 1 in cases where there is a compelling but nuanced case for efficiencies. To mitigate against this, the revised MAGs should include a reference to Phase 1 cases in which the CMA - (and, previously, the OFT - have considered rivalry-enhancing efficiencies in Phase 1 and, in particular, the *DPG/Zoopla* decision,[2] in which the OFT cleared what was effectively a 3-to-2 merger of the second and third largest online property portals, on the basis that it gave rise to rivalry-enhancing efficiencies in the form of network effects that would allow the merged entity to become a credible competitor to the market leader.

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[2] *Anticipated merger between The Digital Property Group Limited and Zoopla Limited*, Case ME/5233/1, 16 April 2021.