ICN Merger Working Group: Analytical Framework Subgroup

PROJECT ON MERGER GUIDELINES

Report for the third ICN annual conference in Seoul

April 2004

PREFACE

This report on merger guidelines, finalised for the 2004 ICN conference in Seoul, follows on from the draft report discussed at the ICN's second annual conference (Merida, 2003). For the first ICN conference (Naples, 2002), the Analytical Framework Subgroup prepared an issues paper, 'The Analytical Framework for Merger Control', which discussed general issues ranging from the purpose of merger policy to the substantive test for merger appraisal and broad questions about remedies. The Subgroup's focus of inquiry since the inaugural ICN conference has been merger guidelines.

At least 26 jurisdictions around the world now have merger guidelines. The draft report focuses on 12 of these, highlighting in particular their common themes and main differences. This overview chapter draws some of these threads together.

The authors of the chapters in this report come from 13 jurisdictions. Each chapter, including this overview chapter, was led by a team with representation from Europe, North America and the rest of the world. Reflecting the ICN's openness and welcome to private sector participants, authors from 16 law firms have contributed to this report. Indeed, it is predominantly the private antitrust bar that has carried out the work reported here, with the OFT as coordinator.

Since the Merida conference, each team of authors has revised and updated their contribution both to incorporate feedback from ICN members at the Merida conference and to reflect the ongoing evolution of guidelines in various ICN jurisdictions. However, this is not the end of the ICN's work on merger guidelines and the overview chapter indicates how the project might be taken forward.

As chair of the ICN's Analytical Framework for Mergers Subgroup, I am most grateful to all who have contributed their time and expertise to this report, and it has been a pleasure to work with Allan Fels and Bill Kolasky on the overview chapter. My particular thanks go to the OFT team that has worked on this project – Simon Priddis, Simon Pritchard, Amelia Fletcher, Clare Tweed, Samina Khan, and especially Steve Lisseter who as secretary to the Subgroup has guided the project.

John Vickers
Chairman
UK Office of Fair Trading

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All chapters of the report are being published on the ICN website – see **www.internationalcompetitionnetwork.org**

CHAPTER 1 - MERGER GUIDELINES: AN OVERVIEW[1]

INTRODUCTION

1. The merger review policies that apply around the world can be compared on three levels. The most general level involves appraisal of merger laws and regulations. For the first ICN conference in Naples in 2002 the Analytical Framework Subgroup prepared an issues paper, 'The Analytical Framework for Merger Control' (the 2002 Paper),[2] which discussed general issues ranging from the purpose of merger policy to the substantive test for merger appraisal and broad questions about remedies. The paper's themes were illustrated by country studies for Australia, Germany, South Africa and the US. The most detailed level of comparative work – which might require a treatise – would examine bodies of casework.

2. The intermediate level, and the subject of the more recent work of the Subgroup, is merger guidelines. Guidelines set out how the authorities intend to apply the laws and regulations in their respective jurisdictions to the cases that come before them. Guidelines are important not only for deliberation on those cases but also for obtaining consistent results in law enforcement. They might influence which merger proposals are made in the first place and they are a mechanism for the authorities to be transparent about the operation of policy, and to be held to account for its proper implementation.

3. For these reasons we believe that merger guidelines are a potentially important and fruitful level to undertake comparative study. This paper is the result of work carried out since Naples and Merida for the Seoul ICN conference. It has five substantive chapters, which deal in turn with topics ranging from market definition to the treatment of efficiencies.

4. This introduction has three aims. The first is to explain how the merger guidelines project has been shaped and carried out. Second, we highlight some findings and themes from the chapters that follow, including major

[1] This project has been overseen by Allan Fells, Bill Kolasky and John Vickers (chair of the subgroup). We have prepared this paper in consultation with the members of the Analytical Framework Subgroup, who have commented on the initial outline and earlier drafts. We are most grateful for their helpful and thoughtful contributions, and to the OFT staff who have seen the project through.
[2] That paper is available on the ICN web site and in the published proceedings of the Naples conference.

developments since the Merida conference. Finally, we list options for future work that will be presented to ICN members at the Seoul conference.

BACKGROUND

5. We agreed at Naples that the guidelines project would have the following elements and would be driven by the private sector:

   a) identify merger guidelines around the world
   b) catalogue their common features and meaningful differences
   c) prepare a template of illustrative analytical practices from the various guidelines that would assist other jurisdictions in preparing their own guidelines, and
   d) present a summary paper to the Merida conference.

6. We identified 26 jurisdictions with merger guidelines and have summarised their scope and coverage in Annex A of this introductory paper. We have divided the guidelines into two groups: those whose guidelines appear to be prescriptive and more or less binding on the authorities, and those whose guidelines appear to be more general and advisory. In drawing this distinction we sought to assess the extent to which the content of the guidelines could be relied upon by parties to a merger as a clear indication of how they could expect the authorities to examine a merger.

7. We recognised that it would not be possible to examine every aspect of all of these guidelines during the period between the Naples and Merida conferences. We therefore decided to examine the five most significant areas:

   - market definition
   - unilateral effects
   - co-ordinated effects
   - barriers to entry/expansion
   - efficiencies

8. We established teams of at least three private sector authors, being one each from Europe, North America and the Rest of the World to work on each of these areas. The members of each team are identified in Annex B. Each team drew on their own contacts and other members of the Working Group to prepare their chapters with particular reference to the guidelines from the 12 countries which were identified as being 'prescriptive':

   - Australia
   - Brazil
   - Canada

- European Union
- Finland
- Germany
- Ireland
- Japan
- New Zealand
- Romania
- United Kingdom
- United States of America

9. Since the original draft chapters were in preparation for the Merida conference, developments in the field of ICN members' merger guidelines have continued apace. For example, in the UK the Office of Fair Trading and the Competition Commission each published guidance in advance of the new merger regime that came into force in June 2003; the New Zealand Commerce Commission issued revised guidelines effective January 2004; in February the European Commission adopted its inaugural guidelines in final form after publishing a draft in late 2002; and the Department of Justice and Federal Trade Commission held a joint workshop to review the U.S. horizontal merger guidelines; most recently, the Canadian Competition Bureau sought comment on its new draft guidelines in March.

10. In an effort to keep abreast of such developments, the chapter teams were invited to provide a post-script to their chapters revised since Merida, or otherwise bring their contribution up to date as they considered appropriate.

FINDINGS

11 In this section we present short summaries of the five chapters noting in particular their key findings on the similarities and differences in the treatment of major topics. We have also added below our own commentary and evaluation of some points raised by the teams, and have indicated where this is so. Moreover, we have also identified a number of other issues that we consider merit further attention, and have similarly identified these. (These added views are expressed as our own, rather than those of the author teams.)

12. We should begin with an overarching point. Since the function of guidelines is to explain an underlying legal test, it is self-evident that guidelines should clearly state how the principles of economic analysis that they set out relate to the underlying legal test. Without this connection, guidelines may well fail in their task of explaining how the legal test will be applied.

Market definition

13. The principal, if not exclusive, goal of merger control in these 12 jurisdictions is the identification and prevention of transactions that create or enhance market power. The most widely used screen for the determination of the possible existence of market power is based on market share, i.e., the percentage of total sales of the relevant product to be held by the merged firm and the distribution of the remaining share among its rivals. Market share values have well-known limitations as a means of measuring market power, which are discussed in the market definition chapter and in the unilateral effects chapter.

14. But market share is nevertheless a basic component of merger analysis. For example, the authors note that high market shares – and significant increases therein resulting from merger – are an imperfect but useful indication of the possible existence and increase of market power. The calculation of market shares presupposes the definition of a market and the identification of the firms participating in it. It is the goal of the market definition process to ensure that these calculations, and thus indications of the possible existence (or not) of market power, correspond as closely as possible to market realities.

15. The team found that the guidelines surveyed shared a broad consensus on the value of sound market definition as a framework for the application of their merger review standard (irrespective of the specific substantive test employed). It might be asked whether a specific market definition exercise is needed as part of merger assessment: if the role of market definition is simply to identify the competitive constraints faced by the merging parties could this not be included within the competitive assessment, where the extent and effectiveness of the identified constraints are assessed? In practice, however, market definition, properly conducted, can bring intellectual rigour and discipline to the identification of competitive constraints.

16. Thus the authors recognise that, although market definition is a useful discipline in screening for market power, it is not an end in itself. It needs to be considered in the context of market dynamics. Put differently, market definition must reflect the relevant underlying competitive constraints faced by the merging parties. Conceptually, these constraints could be analysed directly – for example, by using demand and supply elasticities – but is this practical or desirable? We consider that market definition is a valuable exercise: it focuses analysis of possible changes to, and levels of market power and helps identify the competitive constraints to which the merging parties are subject.

17. The team found that a majority of the guidelines use similar concepts and tools to define markets, again irrespective of the substantive test employed. Nonetheless, we would add that care is needed when applying market definition concepts and tools of the type identified by the authors. This is because it is rarely the case that a market can be easily delineated, and taking too strong a position on the limits of a market might in fact exclude some constraints that do affect competition in that market. In reality, there is normally a spectrum of substitution possibilities that the analytical framework needs to accommodate.

18. Most of the guidelines surveyed by the authors explicitly adopt a version of the hypothetical monopolist test, using existing prices as a baseline, and an increase of five to ten per cent, but preserving flexibility to use different prices or ranges for the test where appropriate. The 2002 Paper asked whether the hypothetical monopolist test is indeed the 'best' test for establishing the boundaries of the relevant market. The authors address this issue by arguing that the SSNIP test represents core concepts of demand and supply elasticity which are integral to sound merger analysis. We note that the precise formulation of the test can lead to different results in practice.

19. The reliability of the SSNIP test[3] however depends fundamentally on the base price chosen for the test. The base price in merger analysis will usually be pre-existing prices (as a proxy of what might be expected in the absence of the merger). But the chapter also discusses whether a different base price might be needed in certain circumstances, such as when there is an already substantially supra-competitive price. Without care, application of the test might then imply that the range of products competing is wider than it really is. This situation is commonly known as the 'cellophane fallacy'. The authors note that this principle might be more relevant in regimes where the substantive test is based on dominance, in as much as the level of market power needs more attention than in SLC regimes which focus attention on the change in the market. We would suggest this as a useful further area of work.

20. The authors note a broad consensus on the importance of supply-side constraints, but identify differences of approach among the surveyed guidelines in whether these are considered as part of market definition, as part of the analysis of barriers to entry, or in the assessment of competitive effects. The chapter concluded that these different approaches should not change the outcome of the analysis. It notes, however, that defining markets by reference to some supply-side considerations could sometimes allow earlier determination that an undertaking would have no significant market power, thus avoiding the need for further analysis.

[3] SSNIP is a widely used acronym for a small, significant non-transitory increase in price.

21. We agree that identification of supply-side constraints is a complex area: not only does recognition of supply-side competitive constraints vary from guideline to guideline, but the conditions for recognising such constraints also vary. For example, some guidelines treat capacity expansion or product repositioning by existing players as part of the entry analysis under competitive assessment, rather than as part of supply-side substitution in market definition. It is clear, however, that what matters fundamentally is recognition of constraints, rather than the labels attached to them. It might be a useful area for further work to clarify the conditions under which supply-side constraints are properly taken into account. Indeed, the authors suggest that a good guideline on supply-side substitutability might involve early consideration of supply-side responses which could occur with little or no investment, with other aspects to be considered later in the analytical process (i.e., after the market has been defined).

22. The guidelines were found to be in broad agreement about the approach to geographic market definition, although some jurisdictions indicate that foreign competition will be taken into account in the competition assessment rather than market definition. The authors consider that this might unduly limit or complicate the analysis, especially of market share.

23. The team found that the treatment of other market definition issues varied considerably. For example, the question of how to treat supply by a vertically-integrated firm to its own downstream business was not always clear. Similarly, the temporal dimension to market definition, the period over which substitution should be assessed, the use of chains of substitution, and the impact of price discrimination (including the question of whether a group of customers is 'captive' to the merging parties) were often expressed in rather vague or flexible terms (and sometimes not at all). The team notes that this provides the possibility of an open-ended and legally uncertain process. They note that there is scope for more guidelines to make more explicit and clear reference to these concepts.

24. Overall, the team found the guidelines on market definition to be helpful and generally transparent. They believed a balance needed to be struck between transparency and flexibility to respond to the real-life situations presented by each case. They note that citation of case law and explanation of general principles can both be very helpful, but that guidelines should avoid becoming so detailed as to become confusing.

25. Finally, the team noted that while some ICN members have recently revised their guidelines, the approach of earlier specific guidelines on market definition has been retained in each case.

Unilateral effects

26. Unilateral effects arise when the merged group is able profitably to raise price, or reduce value for money, choice or innovation through its own acts without the need for a co-operative response from competitors. The chapter examines the treatment of unilateral effects in horizontal, vertical and conglomerate mergers.

27. The 2002 Paper questioned whether there is a wide consensus on the broad analytical framework for evaluating whether a merger will increase market power. The chapter on unilateral effects concentrates more fully on this analytical framework question. It identifies that – with some variations – the guidelines examined generally offer a seven-step approach to examining unilateral effects (i.e., market definition, positions of the merging parties, competitors' positions, market dynamics, new entry, buyer power, assessment against the 'counterfactual').

28. In revising their chapter since Merida, the authors have taken account of recent developments relating to the merger guidelines applicable in the European Union, New Zealand and Canada. In examining how the surveyed guidelines analyse unilateral effects in their latest versions, the authors begin by noting that not all guidelines use this term; the UK and EC guidelines refer to 'non-coordinated effects' to emphasise that the issue in such analysis is not simply whether the merged firm will find it profitable to increase prices post-transaction, but whether it rivals will be similarly situated (because the merged firm's higher prices will drive some customers to its rivals, thus increasing demand for their products).[4]

29. The authors note the existence of a reasonable consensus that high market shares are a prima facie indicator of likely unilateral effects, with higher combined shares increasing the likelihood of concern. As to the application of unilateral effects analysis, the authors suggest that the analysis is more complex and possibly more controversial when the merger combines smaller players in an oligopoly (than in cases where the merged firm is the clear market leader).

30. This observation may well be correct, although we note that the potential competition concern is the same whether or not the distribution of market share suggests the merged firm is 'dominant': as the authors point out in relation to the example given, the concern in such a case will be that the

[4] The proposed advantage of such terminology is that 'unilateral effects' is liable to be misunderstood as referring exclusively to action by a single firm, in particular the merged entity. In merger guidelines, the term is mainly used to refer more generally to independent and hence 'non-coordinated' action by market participants. Future authors of guidelines might wish to consider if this kind of clarification would be helpful to their own readerships.

merger eliminates an important competitive constraint as between the parties and potentially also on their rivals, leading to higher market prices.

31. In introducing unilateral effects, the authors have removed the references in their Merida draft to three basic categories of unilateral effect to take account of the corresponding change between the draft and final versions of the EC guidelines. Thus, rather than identifying the creation of “monopoly” and a “paramount market position”, respectively, as analytically distinct categories within unilateral effects, the authors now identify a single category from among the guidelines that address such effects in detail, with a tendency to focus on two particular fact patterns:

- where the merger combines close substitutes in a differentiated product market; or
- where the merged firm’s rivals face capacity constraints.

32. The articulation of a unified theory of unilateral effects brings welcome clarity as the profusion of terms within merger analysis had been confusing and potentially obscured the real analytical task of identifying whether or not a merger is likely to give rise to competition concerns. Various guidelines, most recently those of the EC, stand for the proposition that two concepts – coordinated effects and non-coordinated effects – capture the possible theories under which a horizontal merger might raise competition concerns.

33. In respect of unilateral effects in a differentiated product market, the authors summarise the analysis here as an inquiry into whether or not
i) the rivalry between the merging parties is important, for example, because the parties’ products are particularly close substitutes (e.g. in terms of product attributes, geographic location or perceived quality or reliability); ii) such rivalry is unlikely to be replaced, for example, by the re-positioning of products by rivals to become closer substitutes;
iii) efficiency gains by the merged entity will create incentives to increase output (and lower price).

34. As to the example of capacity-constrained rivals, the authors summarise the guidelines as predicting adverse non-coordinated effects where the merged entity could profitably decrease output and raise price because its rivals could not respond with increased output and entry was likewise an insufficient deterrent. Reflecting the thinking behind the term ‘non-coordinated effects’ the authors make the observation that even if rivals are not capacity-constrained (i.e. have the ability to increase output), they will lack the incentive to do if it would be more profitable to them to restrict output and enjoy higher market prices initiated by the merged firm.

35. Foreshadowing their discussion of 'safe harbours' relating to market share are used in some jurisdictions, the authors highlight that undue focus on

market share, particularly in differentiated goods markets, may embrace the '0/1 fallacy' whereby all goods 'in' the market are assigned equal weight, regardless of their distinctive qualities, and those outside are accorded zero weight. We agree that rigid conclusions on market definition and reliance on share data can easily obscure the continuum of constraints that characterises competition in many industries and could detract from the fundamental question as to the likely effects of the merger upon competition.

36. Turning to safe harbours based variously on market shares or concentration indices (e.g. HHIs or CR4), the authors observe that these are employed either on a 'strong' basis, with absolute guarantees, or on a 'weak' basis with advisory levels. They can conserve the resources of the authority and offer benefits to notifying parties. An important question raised in the 2002 Paper was the extent to which safe harbours[5] can be relied upon in screening out mergers that raise competition concerns. In addressing this issue, the authors are sceptical about the use of strong safe-harbours. First, such safe-harbours can potentially exclude a questionable transaction from scrutiny. Second, and more practically, because market definition is a difficult exercise (as discussed above), concentration ratios based on particular market definitions are not always reliable indicators of an absence of competition concerns.

37. Accordingly, we note that jurisdictions that seek to place a strong emphasis on precise identification of markets may place greater weight on quantitative concentration measures (reflected in presumptions of anti-competitive effect). In contrast, jurisdictions that use market definition just as an analytical tool to identify the most immediate competitive constraints on the merging parties may approach concentration measures with greater caution. Absent a confidently precise market definition, it is arguable that concentration measures can never be more than a general indicator of the presence or absence of competition concerns. It might not be appropriate then to use a concentration measure either as an absolute safe harbour or as a presumption of competitive harm.

38. Moreover, in deciding how to approach questions of concentration measures and safe harbours, competition authorities need to balance ease of application (for both regulators and business) against predictability of outcomes. Another way of looking at this is that authorities may need to decide whether to focus attempts to minimize Type 1 errors (challenging non-problematic mergers) or Type 2 errors (clearing problematic mergers). This may impact on the choices made as to whether to adopt 'hard' or 'soft' safe-harbours, for example.

[5] A safe harbour is a threshold concentration measure below which a merger will not be challenged.

39. The authors raise five issues related to estimation of market shares and concentration: (i) the overall objective (is it to arrive at the best proxy for market power, or a worst-case screen?); (ii) the appropriate criteria for measuring share, including (iii) the time frame; (iv) treatment of captive production; and (v) measurement of market concentration. In relation to the latter, the authors note that HHIs are generally preferred as a measure of concentration since the measure relates not only to the position of the merging parties but also the positions of rivals.

40. We also consider that guidelines using concentration measures – including HHIs – need to incorporate an indication of the levels and prospective changes in concentration as a result of the merger that are likely to give rise to further investigation. Setting the appropriate levels of concentration and increases in concentration is not, however, straightforward. It is also arguable that different levels and increases are appropriate for different sizes of economy and for economies at different stages of development (e.g., transition or mature economies).

41. The authors also raise questions as to whether guidelines state clearly enough how unilateral effects theory might apply to (i) acquisition of potential competitors; (ii) monopsony issues i.e. the creation or enhancement of market power in a procurement market and (iii) a failing firm defence. The authors also note scope for (more) guidelines to acknowledge that market shares may be of limited use in assessing unilateral effects in differentiated product industries.

42. In sum, the basis on which guidelines describe unilateral effects may vary, but there appears to be a reasonable consensus on the sorts of factors that will be taken into account by competition authorities in reaching a view.

Coordinated effects

43. Competition law has long been concerned that the loss of a firm through a merger, joint venture or other concentration may facilitate coordination among the remaining firms in the industry, leading to reduced output, increased prices or diminished innovation. The analytical framework used by competition authorities has recognized this fundamental competitive effect in a variety of forms, treating it in some cases with detailed discussion and analysis, but just briefly in others.

44. The team observed that the treatment of coordinated effects in the surveyed guidelines was potentially sensitive to the nature of the substantive test. More specifically, the authors conclude that, although the original EC Merger Regulation was applied in coordinated effects cases (and upheld by the CFI), jurisdictions utilizing a 'dominance' standard may require judicial

confirmation that they have legal authority to challenge mergers on coordinated effects grounds using the dominance test.

45. This is an interesting assessment by the authors since at first sight there would appear to be no real difference between the dominance and SLC tests in the way in which they treat coordinated effects. Separately, in addition to the thesis advanced by the authors, another possible implication of the choice of substantive test for treatment of coordinated effects is in relation to handling of possible non-coordinated oligopoly cases. It is arguable that, given doubt as to the precise terms of the dominance framework, cases that partly involve non-coordinated effects concerns have been brought instead under the coordinated effects concept, which can involve significantly more complex economic analysis than non-coordinated effects cases. Thus, there may be greater risks of clearing anti-competitive mergers under the dominance framework than under the SLC framework.

46. The authors then discuss the relationship between concentration ratios and the scope for coordinated effects, noting that some guidelines establish absolute safe harbours while others provide indicative, but non-binding, safety levels. In addition, we note that some jurisdictions place substantial weight on concentration measures to found, or in some cases presume, coordinated effects.

47. The 2002 Paper asked how the merger review process should evaluate whether a market is susceptible to coordination. The authors highlight that there is uniform recognition of the three main factors that might lead to co-ordination. First, the coordinating parties must be able to establish terms for coordination. Second, the participating parties must be able to monitor adherence to the coordinating behaviour. Third, effective deterrence mechanisms must exist to prevent parties reneging on coordinating behaviour. The chapter also notes that some guidelines list additional factors, or market characteristics, which might be relevant in particular circumstances. The authors suggest that more detailed discussion of these areas in merger guidelines could reduce uncertainty of merger review and deter some potentially anti-competitive mergers.

48. Finally, the chapter notes that some guidelines consider how the merger itself might facilitate coordination other than by simply reducing the number of competitors in the market. For example, the United States considers whether the merger leads to the elimination of a collusion-destabilizing maverick.

Barriers to entry and expansion

49. A merger that materially increases market concentration may not be anti-competitive if new firms could enter the market, or if incumbents could readily expand production, to prevent the exercise of market power.

50. At the outset, we note that entry considerations should be integral to the competition assessment and not just as a 'defence' to possible concerns. Though entry may often constrain market power post-merger, some guidelines acknowledge that a merger may have adverse effects on competition because it increases barriers to entry to a particular market and thus reduces the effectiveness of entry as a competitive constraint. This is not, however, common across all guidelines.

51. The chapter describes how various jurisdictions assess entry and expansion, including a discussion of the possible forms of new entry. The authors also address the issue of the effectiveness of entry. In short, most guidelines require that to be effective in constraining post-merger market power entry must be likely, sufficient and timely. There is broad agreement between the surveyed guidelines on the basic concepts, but the chapter notes some differences on the harder question of how to perform the assessment in specific cases.

52. When assessing the likelihood of entry, the US and Brazil approach is based on a quantitative minimum viable scale (MVS) analysis. It is usually the case that the MES test requires a higher level of sales activity than the minimum viable scale. The team is however unsure if the different approaches might lead to different outcomes in practice and notes the scope for further work in this area.

53. Judgments of the likelihood of entry must be fact-based. Firms relying on prospective entry to rebut concern about a potentially problematic merger will need to produce evidence of genuine likely entry. It will rarely be enough for firms to show, in the abstract, that entry is possible: most guidelines also state – though not all are clear on this – that actual entry must be likely.

54. In most guidelines the issue of entry being sufficient (to offset potential problems) is closely linked to that of likelihood, but some guidelines note particular exceptions – e.g. where the new entrant would be able to compete for only a small or distinct part of the market.

55. Finally, there is broad agreement that entry must be timely – i.e. it must occur in a timescale that is short enough to deter or render unprofitable the exercise of market power in the context of the market concerned. The authors note that this time period may differ from case to case, depending

on the particular facts. They observe that most merger guidelines indicate time periods of up to two years in which such entry may take place (with some regarding activity within one year as supply-side substitution to be taken into account in market definition).

56. We have already noted above the relationship between supply-side substitution and entry as constraining factors. What matters is that all real competitive constraints are taken into account, rather than the labels attached to them.

Efficiencies

57. Since Merida, the authors have revised this chapter to take into account the new merger guidelines of the OFT and the Competition Commission in the UK, as well as the new European Community Merger Regulation (ECMR) and the new horizontal merger guidelines. The chapter also considers recent developments and case law in New Zealand and in Australia, and addresses developments in Canada in respect of its draft legislation to remove the statutory efficiency defence in force. There is further discussion on the types of efficiencies that may be considered together with the method under which efficiencies may be balanced against the anti-competitive effects of a merger. The authors also raise the applicability of a more flexible consideration of efficiencies for countries with small or developing economies.

58. The authors of this chapter begin by noting, as did the 2002 Paper, that the way in which efficiencies are incorporated into the review of mergers by a competition authority is itself an important policy question.

59. In particular, the 2002 Paper asked whether efficiency evidence was best taken into account as part of the competition analysis (showing that a market might be made more competitive by the merger) and/or as a countervailing justification for an anti-competitive merger (in which an adverse effect on competition may be permitted on the grounds that efficiency benefits, especially those accruing to consumers, outweigh the competition problem). The 2002 Paper noted that this depended in part on how the merger law was expressed and how its core purpose was interpreted.

60. The authors look at the surveyed guidelines in this light. They note the debate about whether efficiencies reaped by producers in the form of profit gain should be considered in addition to those that benefit consumers, and in particular the extent to which cost savings are passed on to consumers in the form of lower prices. From the economic stand-point, the authors consider that there appear to be a number of reasons for assessing efficiency gains to both consumers and producers. By assessing only

benefits to consumers, they conclude, a zero weight is assigned to producer profits which they argue disregards the fact that gains to producers can be socially positive. (We would add, however, that the stance of merger policy affects not only how mergers that present themselves are assessed, but also which mergers are proposed in the first place. A full welfare assessment of policy would take account of the latter as well as the former issue.)

61. The fact that the surveyed guidelines do not, in the main, account for increases in producer efficiencies is, in our view, largely a policy decision. Legislatures and those responsible for merger decisions have generally concluded that the core purpose of their merger control regime is to protect consumers (or customers). It seems clear that – of all the substantive issues raised in the chapters – the issue of efficiencies raises some of the sharpest questions about the underlying goals of merger control laws. For this reason, and because of the information asymmetry issue discussed below, competition authorities should give particularly careful thought to the efficiencies sections of guidelines.

62. The authors make a further point about the requirement in many guidelines that efficiencies be passed on to consumers (at least in good part).[6] They conclude that, with this requirement, the efficiencies defence will rarely be of use because the transactions where 'passing on' is likely to arise will themselves rarely be problematic. This is because they consider that the 'passing-on' requirement effectively requires a competitive market. (We would note, however, that as a matter of economics, even a monopolist would pass on a proportion of marginal cost savings to consumers.)

63. The authors also address the issue of whether efficiencies ought to be merger specific – i.e. they would not arise in the absence of the merger. Almost all jurisdictions studied state that any efficiencies claimed must be merger specific, thus they must be considered within the context of alternative means by which they could be achieved. This requirement can generate complications, requiring competition authorities to consider the realism of hypothetical alternatives.

64. The 2002 Paper raised the question of whether competition authorities should be sceptical of efficiency claims in mergers that raise competition issues. Scepticism (in relation to such mergers) arises from informational asymmetry and difficulties in measuring the expected value of any efficiency. The authors comment that in some cases the evidentiary burden of proof imposed on the merging parties appears to be greater with respect to efficiencies than that imposed on competition authorities with respect to anti-

[6] There is also the question of which consumers count in the reckoning of benefits – just those in the affected markets, or others too?

competitive effects. This may reflect a cautious approach (either at the screening or at the determinative stage of merger review) to transactions that are perceived to have anti-competitive effects. The chapter argues that this could have detrimental effects on welfare given the social costs that are incurred in blocking mergers that may produce synergies.

65. But in our view this sceptical stance – or at any rate, placing the burden of proof on the parties when they make efficiency claims about mergers raising competition concerns – may be the correct approach given the very significant information asymmetries between the merging parties and the competition authority in relation to efficiency claims. That said, there is question of how far scepticism should go, and the risk that if carried too far, pro-competitive (or pro-consumer) mergers would be stopped.

66. The team reviews the detailed approaches to efficiency analysis and argues that competition authorities should adopt more consistent approaches. This would imply further work on which efficiencies should be considered; how they should be quantified (and discounted if necessary); and how they should be weighed against perceived detriment to competition and consumers.

67. In sum, the guidelines reveal a diversity of approaches to the treatment of efficiencies. The authors have provided a thought-provoking analysis which should lead to an interesting debate.

CONCLUSIONS AND SUGGESTIONS FOR NEXT STEPS

68. We began by remarking that the merger policies that apply around the world can be compared on three levels: laws and regulations; guidelines; and casework. Our first concluding observation is that, notwithstanding international diversity of the wording of merger laws and regulations, the merger guidelines that this project has compared have a lot – perhaps a surprising amount – in common.

69. For example, there is a great deal of common ground in the approaches to market definition, with almost universal acceptance of a form of the hypothetical monopolist test and with recognition that market share values are a tool to be used as a step in a case-by-case analysis rather than providing an answer that needs no further consideration.

70. Our second conclusion is that, nevertheless, there are important differences between guidelines. These differences relate in part to the nature of guidelines and in part to their treatment of substantive issues.

71. As to the nature of guidelines, some are considerably more detailed and comprehensive than others. No doubt this partly reflects differences in the accumulation of case law, decisional practice and experience under different regimes. But it also illustrates an underlying dilemma. Guidelines, by their nature, are independent of the facts of particular cases. Detailed prescriptive guidelines may have merits in terms of clarity about how the authorities will treat cases, but the risk is that they will unduly constrain case analysis, or become so long and complex that clarity is diminished rather than enhanced. (This dilemma is somewhat reminiscent of the debate between *per* se and rule-of-reason analysis in non-merger antitrust.) But a dilemma is not a reason to do nothing. Good and transparent merger guidelines, without unduly constraining the analysis of cases, should bring benefits in terms of highlighting what kinds of evidence matter most in merger appraisal. Thus they can usefully focus the fact-based analysis of cases.

72. On the treatment of substantive issues, there is much in common across approaches to market definition, unilateral effects and co-ordinated effects. However, the relative importance attached to the latter two kinds of competitive effect perhaps varies according to the substantive merger test.

73. There appears to be more variation in the treatment (i) of supply-side constraints from entry and expansion of firms other than the merging parties, and (ii) of efficiencies. On (i) it is partly a question of how competitive constraints are labelled: what might count in market definition as 'supply-substitutability' in some regimes might be treated separately as 'entry' in others. This should not lead to different final results of the competition assessment provided that all relevant supply-side constraints are properly reckoned into the analysis at some point.

74. On efficiencies, there are several sources of difference – for example, as to whether efficiencies should count within and/or after the competition assessment; whether producer surplus should have weight; and what is the burden of proof on parties making efficiency claims in cases of competition concern.

Next Steps?

75. Now that this part of the project is complete, the question is how to develop this line of ICN work. A number of options, have been identified, and ICN members are invited at the Seoul conference to vote on their preferred choice. The favoured option will be taken forward and its development will be jointly chaired by the OFT and the Irish Competition Authority: In brief the options are:

i) Compilation of an agreed checklist of topics which should be covered in merger guidelines

ii) Review of market share data associated with merger prohibitions/challenges

iii) Review of a variety of merger remedies

iv) Compilation of a case database with links to reasoned decisions

v) More in-depth study of a topic already considered under the guidelines study

vi) Wider application of the guidelines study to regimes that have yet to develop guidelines.

vii) Consideration of the nexus between guidelines and cases

viii) Investigation of the analytical economic basis for elements of the merger guidelines

ix) Any alternative topics

76. On these and other points we keenly anticipate the discussion at Seoul!

ANNEX A -
SCOPE OF MERGER GUIDELINES IN JURISDICTIONS REVIEWED

Country		Substantive Test				Scope of Guidelines			Market Definition			Market Structure and Concentration			
	Statutory Provision	Dominance	Restriction of Competition	Public Interest	Other	Horizontal	Vertical	Conglomerate	Product Market	Geographic market	Other (eg temporal)	Market Shares	Concentration Ratios (eg CR4)	HHI	Other
Australia	√		√	√		√	√		√	√	√	√	√		
Brazil	√				√	√	√	√	√	√	√	√	√		
Canada	√		√			√	√	√	√	√		√	√		
EU	√	√				√						√		√	
Finland	√	√				√	√	√	√	√		√			
Germany	√	√				√	√					√			
Ireland	√		√			√	√	√	√	√		√	√	√	√
Japan	√		√			√	√		√	√	√	√	√		√
New Zealand	√		√			√	√	√	√	√	√	√	√		√
Romania	√					√	√		√	√					
UK (CC)	√		√			√	√		√	√	√	√	√	√	√
UK (OFT)	√		√			√	√	√	√			√	√	√	
USA	√		√			√			√	√		√		√	√

Country	Competitive Effects/Market Characteristics										Special Provisions					
	Unilateral Effects	Coordinated Effects	Market wide effects	Barriers to Entry/Expansion	Buyer Power	Import Competition	Failing Firm	Innovation Effects	Efficiencies	Other	Financial Strength	De Minimis Considerations	Public Interest	Undertakings offered	Exemptions/Exclusions	Other
Australia	√	√		√	√	√	√	√	√	√			√	√		
Brazil	√	√		√	√	√		√	√				√			
Canada	√	√		√		√	√	√	√	√						
EU	√	√	√	√	√		√	√	√					√		
Finland	√	√		√	√	√	√		√	√				√		
Germany	√	√	√	√	√		√	√		√	√					
Ireland	√	√	√	√	√		√	√	√							
Japan				√		√				√						√
New Zealand	√	√		√	√	√	√		√	√						
Romania																
UK (CC)	√	√	√	√	√		√		√	√			√	√		
UK (OFT)	√	√	√	√	√		√		√			√	√	√	√	√
USA	√	√		√			√		√							

ANNEX B - PRINCIPAL MEMBERS OF THE WORKING GROUP

Secretariat
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CHAPTER 2 - MARKET DEFINITION[1]

OVERVIEW

1.1 This Chapter discusses the treatment of market definition in the merger guidelines of twelve jurisdictions (the "Guidelines").[2] The first section briefly summarizes the role of market definition in the analysis of the competitive effects of mergers and references a brief historical overview. The remaining sections review the main features of the Guidelines.

I. MARKET DEFINITION AS AN ANALYTICAL AND DISCIPLINARY TOOL

a) Why Market Definition?

1.2 The principal, if not exclusive, goal of merger control in these twelve jurisdictions is the identification and prevention of transactions that create or enhance market power.[3] Market power is variously defined in the relevant jurisdictions but a definition that might be viewed as common to all would be the ability of the merged firm, or of the firms remaining in the market after the merger, to profitably raise prices significantly above (or reduce output significantly below) competitive levels (or otherwise to reduce rivalry). The objective (and challenge) of merger control is to prevent those mergers that do pose such a threat while not impeding those that do not.

1.3 Market power might best be reflected by (i) the elasticities of demand (the percentage change in quantity demanded of the product or services concerned in response to a 1 percent change in its price) and of supply (the percentage change in quantity supplied in response to a 1 percent change in price) faced by sellers of the product in question or (ii) by the residual demand curve of the merged firm.[4] In other terms, the question of whether a transaction creates or enhances market power could be resolved if one could calculate whether post-closing the merged firm could significantly raise prices without suffering sufficient reduction in demand to make the price increase unprofitable. For example, the question of whether a merger creates unilateral market power can be answered by calculating the merging firms' residual elasticities of demand and the extent of the premerger substitution between the firms. However, the complex measurement of variables that affect demand and supply usually require a range of reliable market data that is frequently unavailable.[5] Moreover, these calculations are more likely relevant in unilateral effects cases (where the issue is whether the transaction creates a firm that can exercise market power on its own) rather than in coordinated effects cases (where the issue is whether the firms remaining post-transaction will be able to exercise market power collectively because of the change in market structure caused by the transaction).

1.4 Of course, there are other ways to attempt to evaluate whether a transaction may lead to market power. One can examine internal documents and interview knowledgeable personnel at the merging firms and at those firms' customers, suppliers, competitors, etc.[6] Indeed, it is now widely recognized that the input of affected economic actors should be obtained wherever there is a need for a serious inquiry into the market power issue. On the other hand, without an analytical framework guiding this inquiry and the evaluation of the material obtained, this undertaking may be unproductive in evaluating the economic issues posed by a transaction.

1.5 In short, there is frequently not enough reliable data to calculate elasticities and insufficient documentary or other direct evidence standing alone to determine with confidence whether a transaction is likely to significantly reduce competition. An analytical framework is therefore necessary to focus and guide the inquiry.

1.6 The most widely used proxy for the determination of the possible existence of market power is market share, e.g., the percentage of total sales (or some other measure) of the product to be held by the merged firm and the distribution of the remaining share among its rivals. To calculate market share presupposes the definition of a market and the identification of the firms participating in it. The goal of the market definition process is to ensure that these calculations correspond as closely as possible to market realities.

1.7 In many cases, then, market definition is a first step in the process of evaluating whether a transaction creates market power as it allows the calculation of market share and of concentration indices based on sales, production, or capacity. These calculations, in turn, give at least an indication, however imperfect or rebuttable, of whether a post-transaction dominant firm or oligopoly can raise prices above the competitive level or otherwise reduce competition.

1.8 While it is important to recognize the value of market definition as a flexible analytical tool, it is equally important to understand its limitations both in capturing market dynamics and in answering the ultimate issue of whether the transaction will create or enhance market power. Most of the Guidelines recognize explicitly (e.g., U.K. (CC) Guidelines) or implicitly (e.g., Finland, New Zealand, the EC, and the U.S.) that market definition is not an end in itself but a useful discipline in many cases.

b) Evolution of the Concept

1.9 While the Clayton Act (the U.S. statute prohibiting anticompetitive transactions) had since 1914 prohibited any transaction the effect of which "may be substantially to lessen competition," there is little in the legislative history that interprets this term and, as with the Sherman Act, the courts and enforcement agencies were left to give meaning to vague statutory language.[7] The use of market definition as an analytical tool in merger cases was not introduced in U.S. courts until the late 1940's.[8] By the late 1950's and early 1960's, however, product and geographic market definition was playing a central role in U.S. merger analysis, and yet there were no standards guiding the process.

1.10 In 1968, in the first set of merger guidelines issued by the U.S. Department of Justice ("DOJ"), market definition was included as a formal first step in the evaluation of the competitive effects of a merger.[9] But guidance on how to define a market was at a minimum confusing and was severely criticized at the time by a presidential task force.[10] Even in the early 1980's, there was no consensus on a sensible way to define markets and frequent criticism of how the enforcement agencies and the courts defined markets, e.g., their conclusions on market definition were often thought to be designed to achieve a pre-ordained result of prohibition.[11] In 1980, a Harvard professor and former Assistant Attorney General in charge of the DOJ's Antitrust Division said that the case law on market definition was "a bloody mess."[12]

1.11 The 1982 DOJ Merger Guidelines addressed this situation and formalized a methodological approach to market definition that had evolved through the preceding decade. The then-head of the Antitrust Division, Stanford Professor William H. Baxter, was committed to bringing economic rigor to the process. The effort was successful and over time, the "smallest market principle" and the "small but significant non-transitory increase in price" (SSNIP) test (see below) have become, with some variations in subsequent guidelines of other countries, the predominant analytical tool in merger analysis.

1.12 The twelve Guidelines under discussion in this paper were adopted between 1991 (Canada) and 2003 (U.K. (CC) Guidelines), and in all of them market definition plays a central role in the assessment of mergers – in some of these jurisdictions the role of market definition has been approved by the highest judicial authorities.[13] Most of these Guidelines have also adopted some form of the SSNIP test or its equivalent.

1.13 It is important to understand, however, that as critical a step as market definition may be in most cases, it should not be confused with the overall objective – the evaluation of the likely competitive effects of a merger. Several Guidelines explicitly recognize the subsidiarity of market definition to the assessment of the competitive effects of a merger.[14] For example, the Irish Guidelines make clear that market definition is not a required step in all instances.

> [T]he approach to market definition…is not mechanical, but rather a conceptual framework within which relevant information can be organised. In particular, it will not always be necessary for the Authority to reach a firm conclusion on market definition. This will be the case, for example, where it is clear that the merger does not raise competition concerns on any reasonable definition of the market. Alternatively, the Authority may not

define a market if the transaction clearly gives rise to adverse competitive effects.[15]

Nonetheless, the recognition that market definition is only a means to an end does not negate the need for the adoption of sensible and transparent guidelines on this issue in all jurisdictions enforcing merger control. Also, to the extent that a jurisdiction's market definition methodology introduces analytical rigor and discipline into the evaluation of the market power issue, it can add enormous value to the process. The conceptual breakthrough represented by the SSNIP test, for example, contributed not only to the market definition process but also to the fuller understanding of what constitutes market power and what does not.[16]

c) The Relationship of Market Definition to the Applicable Substantive Standard

1.14 At the risk of overgeneralization, the Guidelines of the twelve jurisdictions in question appear to reflect two different standards for evaluating a merger: in seven of the Guidelines a transaction is likely to be deemed unlawful if it leads to a substantial lessening of competition ("SLC") while five of the Guidelines ask whether it leads to a strengthening of "dominance."[17] There appears to be a broad consensus on the value of sound market definition as a framework for the application of either standard and a majority of the Guidelines use similar concepts and tools (with varying degrees of detail and explanation) to define markets irrespective of the substantive test employed.

1.15 The question arises whether market definition is more important in applying one or the other substantive standard. Under an SLC standard, market definition (at least in a coordinated interaction case) is likely to be highly useful to the analysis because the likelihood of coordinated effects turns on the number of rivals, the availability of substitutes, the distribution of share, and the existence of excess capacity and of detection and punishment mechanisms, etc. On the other hand, market delineation under a dominance standard would seem less important: evidence that the firm has significant market power, e.g., margin data, together with evidence of significant substitution between the production of the merging firms might provide significant evidence regarding competitive effects without the need to define a market.[18] It might seem, therefore, that market definition would be less critical in the Guidelines of jurisdictions operating under a single firm dominance standard. If anything, however, the opposite seems to be true. This may be because some authorities implementing a dominance standard operate under legal standards that are perceived to require a finding of a certain minimum market share before dominance can be established, and perhaps because these authorities have underemphasized evidence of the firms' residual demand elasticity.

1.16 In any event, regardless of the applicable substantive standards, market definition is a key component of merger analysis and the analysis of marginal substitution that underlies it also focuses consideration of the market power question.

II. PRODUCT MARKET DEFINITION

a) Demand-side substitutability

1.17 In virtually all of the Guidelines, the process of defining the product market begins with the identification of the goods or services supplied by the merging firms. The next step is to identify the goods or services that may be considered by customers to be practical substitutes to these goods or services (demand side substitutability). Some of the Guidelines state explicitly that these products must be economic or "close" substitutes. The goal of demand-side analysis is to identify and include in the market only those substitutes whose prices and other characteristics constrain the ability of the merging firms and their rivals from raising prices or reducing output.

1.18 Most of the Guidelines cite a mixture of qualitative and quantitative criteria to assist in identifying products that are "in" or "out" of the demand side of the market. Some use descriptive, largely static criteria such as "physical characteristics" and "end use." Similarity in price is also used as an indication of whether products may be close substitutes. The perceptions of market participants of the role of the product is also included in some Guidelines. These criteria are useful in excluding many products from consideration but alone cannot answer the question of economic substitutability, i.e., the extent to which a product or products would be included in market definition because its pricing constrains the ability of the merged firm to raise the price or reduce output of the product in question.

1.19 Only seven of the Guidelines seem to take account of qualitative factors that go beyond physical properties, end uses, and industry perceptions.[19] For example, switching costs, e.g., the costs borne by a buyer switching from one product to another, are referenced in only six of the Guidelines.[20] Only three of the Guidelines refer to the concept of a "chain of substitution" that may exist in certain consumer products (autos, furniture, clothing, etc., see below).[21] Also, the idea of comparing the movement of prices of the products in issue over time to determine if there are similarities is also contained in only a minority of the Guidelines. The economic concept of price discrimination (see below) is referenced in only seven of the Guidelines despite the fact that it may be outcome-determinative in at least some cases.[22] To be sure, these concepts are not affirmatively rejected in any of the Guidelines, and may well be used frequently in those jurisdictions. In any event, the twelve Guidelines differ significantly in the breadth and depth of the relevant factors employed in the market definition exercise.

b) The SSNIP test

1.20 Eight of the Guidelines explicitly adopt the SSNIP test.[23] The objective of the test, according to the Canadian Guidelines, is to identify

> the smallest group of products and smallest geographic area in relation to which sellers, if acting as a single firm (a 'hypothetical monopolist') that was the only seller of those products in that area, could profitably impose and sustain a significant and nontransitory price increase above levels that would likely exist in the absence of the merger.[24]

1.21 As noted in the introduction, the SSNIP test has been widely accepted as the tool to implement the "hypothetical monopolist" test for market definition. The test is designed as a sometimes rough but often useful way to probe the boundaries of the product and geographic markets.

1.22 The SSNIP is an iterative process beginning with the narrowest possible product definition (or geographic area) and querying whether a “hypothetical monopolist” (i.e., a firm controlling the entire output of the product (or geographic area) as defined) could profitably maintain a SSNIP. If the SSNIP would be profitable then the next closest substitutes are added to the product group (or the geographic area is expanded) and the process is repeated. This process continues until a set of products (or geographic area) is found where a “hypothetical monopolist” would be unable to profitably impose a SSNIP.

> To illustrate, consider a proposed merger between two companies manufacturing prescription sleeping pills. If a single firm controlling all brands of prescription sleeping pills would find it profitable to impose a small but significant and nontransitory increase in price (SSNIP) for at least one of the brands sold by the merging parties, then prescription sleeping pills constitute a relevant product market. If not, then the next-best substitute, e.g., non-prescription sleeping pills, is added to the candidate relevant market and the test is repeated.[25]

1.23 The test may seem easier to use in industrial input markets where the number of buyers is relatively small (i.e., many if not all can be interviewed) and where the buyers routinely consider substitution choices. But there can be difficulties in applying the test in the industrial context because a customer’s response to a hypothetical question might not provide reliable evidence of what actually would occur when relative prices change. The test can also be difficult to use in highly differentiated products (especially consumer goods) because reliable customer surveys are not always available and because customers have non-monetary reasons for their purchasing decisions. On the other hand, when data suitable for estimating demand elasticities are available for differentiated consumer products (e.g., Neilson data, grocery chain data, etc.) and for commodities, applying the hypothetical monopolist test can be relatively straight-forward.

1.24 In any event, while the SSNIP test has become synonymous with market definition in many jurisdictions, the Guidelines of some (e.g., Finland, Japan, and Romania) do not refer to the test at all. This seems unfortunate because, as noted above, the SSNIP test has introduced some discipline into what otherwise can be an unwieldy and open-ended inquiry. In other terms, the core concepts of demand and supply side elasticity that the SSNIP test represents should be a part of a sound merger control system, whether embedded in the market definition methodology or elsewhere in the analysis.

1.25 Two difficult issues raised by the use of the SSNIP test are (i) the prices to be used as the basis for the hypothetical question (i.e., assuming the price of the product were X, if X rose by 5%, would you switch to another product?) and (ii) the appropriate price increase to be postulated. The treatment of these issues in the Guidelines is outlined below.

Base price under the SSNIP test

1.26 Using an appropriate base price for the SSNIP test is fundamental. The base price affects whether customers would switch to alternative products (and other firms switch to producing these products) in response to a price increase and thus affects the delineation of the "smallest" market in which to measure share and then to evaluate the market power issue. The base price also affects the "critical loss" analysis of a transaction, i.e., the maximum reduction in quantity sold that a hypothetical monopolist would find profitable.[26]

1.27 Seven of the Guidelines discuss the base price to be used for the SSNIP test.[27] These Guidelines generally suggest that the "prevailing market price" be used.[28] Four of them (i.e., EC, Ireland, New Zealand, and the U.K. (CC) Guidelines) state that where the prevailing price does not appear to be the competitive price, a competitive price should be substituted. The Guidelines of several jurisdictions (e.g., the EC and New Zealand) allude to possible reasons why the prevailing price is not the competitive price but do not advise how to determine the appropriate base price.[29]

1.28 The danger of using an inappropriate price for defining markets is illustrated by a 1950's U.S. monopolization case. The U.S. Supreme Court concluded that a producer of cellophane did not have market power due to the strength of substitutes for cellophane. But the Court failed to recognize that these products were only good substitutes for cellophane at the monopoly prices of cellophane already charged by the defendant, i.e., at a competitive price for cellophane, these products were not economic substitutes. (Because of the product involved, the error made by the Court has become known as the "cellophane fallacy"[30] – the Australian, U.K. (CC) Guidelines, and U.K. (OFT) Draft Guidelines expressly refer to the case.)

1.29 Where the prevailing price is well above the competitive level but the likely future price is significantly closer to the competitive level (due to, for example, a likely reduction in the effective degree of coordination), using the prevailing price as the SSNIP base price may lead to erroneous assessments of the effects of the merger: where the merging firms both produce the same (or nearly the same) products it will tend to understate the actual competitive effect of the transaction by including in the market products that will not be fact substitutes for the merging firms' products at the lower likely future price. On the other hand, where the merging firm's products are only good substitutes at the (higher) prevailing price, it will tend to overstate the potential competitive effect of the transaction. In short, identifying and utilizing the "correct" base price for purposes of the SSNIP test is important to the market definition analysis and for evaluating the competitive effects of the transaction.

1.30 Four of the Guidelines discuss the possibility of using prices that would prevail in the future absent the merger when they can be predicted with reasonable reliability.[31] The Australian Guidelines indicate that future prices absent the merger are the most appropriate base price for application of the SSNIP test because those prices most accurately reflect the prices customers would actually use in their switching decision absent the merger.[32] No methodology is suggested for selecting the appropriate future price. The Irish, U.K. (OFT) Draft Guidelines, and U.S. Guidelines each give the example of a change in regulation as an event that may predictably change prices.

1.31 It is useful to consider two distinct purposes for using a base price: the first is assessing what products and firms would limit the ability of the merging firms to increase price post merger. The second is assessing whether one or both of the merging firms have (significant) market power prior to the merger in order to evaluate whether one of the firms may already have a dominant position. For the first purpose, using the likely future price as the base price to delineate such substitutes seems appropriate. For the second purpose, avoidance of the cellophane fallacy would appear to entail using as a "base" price the competitive level.

Size of price increase under the SSNIP test

1.32 A 5 % price increase is the most popular benchmark for the SSNIP test. One jurisdiction, Australia, refers only to a "relatively small percentage increase." The Canadian, U.K. (CC) Guidelines, and U.S. Guidelines indicate that a larger or smaller price increase may be used where the application of 5% increase would not reflect market realities, though none provide much guidance on how to determine when this is the case. Ireland uses a 5-10% increase as a base. The EC refers to a 5-10% range and Brazil to a 5, 10 or 15% price increase depending upon the circumstances. Most of the guidelines acknowledge that no single percentage is correct in every case. For example, the U.K. (OFT) Guidelines 1998 refer to the 5-10% test as a "rough guide." Also, as a practical matter, enforcement agencies have from time to time used a price increase as low as 2% in assessing possible supply responses (especially in defining geographic markets – see below) in high-volume, low margin products such as petrol or groceries. The U.S. Federal Trade Commission, for example, has used price increases lower than 5% when evaluating the likely supply responses of relatively distant suppliers of gasoline when defining local or regional geographic markets for their products. Also, the 5% test is a market definition standard, not the standard for the magnitude of post merger price increase that is unacceptable. That might be as little as 1 or 2% -- depending on the circumstances.[33]

1.33 Several Guidelines (e.g., New Zealand and the U.K. (CC) Guidelines) also acknowledge that there are markets in which the SSNIP test is not normally used because it cannot produce useful information. For example, in so-called bid markets like building or highway construction contracts, there is generally no prevailing or competitive price on which to base the test. The relevant market is generally defined by reference to those firms capable of bidding and the issue is whether the transaction reduces the number of bidders, say, from 4 to 3. The same approach probably applies to most transactions in defense industries.

c) Supply-side substitutability

1.34 Firms not currently selling a product in competition with that of the merging firms but that could readily do so within a short period of time in reaction to a price increase can constrain the exercise of market power just as effectively as consumers on the demand side switching to alternative products. On the other hand, for supply substitutes to be considered an effective competitive constraint, suppliers must be able to switch production to the relevant product in a short time period without incurring significant additional costs or risks. The SSNIP test is employed in many of the Guidelines to determine what supply substitutes to include in the market.

1.35 Most of the Guidelines in one form or another acknowledge the importance of the supply-side in determining the issue of whether a transaction would create market power. A majority of the Guidelines use supply-side substitution in defining the boundaries of relevant markets.[34] (A notable exception is the U.S.; see below). In addition, while the Brazilian, EC, Finnish, Irish, Japanese, and Romanian Guidelines indicate a preference for demand-side substitutability factors, supply-side factors may also be considered if they are as effective a constraint on the hypothetical monopolist as demand-side substitutes.

1.36 Some Guidelines establish an express hierarchy between demand-side and supply-side factors: markets must be defined "primarily from the standpoint of consumers" (Ireland) because demand is considered "the most immediate and effective disciplinary force" (EU). Others simply mention demand-side and supply-side factors in turn.[35] However, all the Guidelines that provide for the inclusion of supply substitutes in the relevant market put conditions on their inclusion. These conditions generally relate to the time within which the supplier can in fact respond with a product competitive with that of the merging firms and the cost (investment) needed to respond.

1.37 In order to be considered at the market definition stage, the Brazilian, Canadian, Irish, New Zealand, and the U.K. Guidelines state that the response should generally occur within a year of the price rise. All of these Guidelines acknowledge that the exact time period will in each case depend on the nature of the market and specific circumstances of the case. The EC, Finnish, and Romanian Guidelines do not specify a time period but instead use the words "short term," "quickly," and "reasonable period," respectively.

1.38 The U.K. (OFT) Guidelines 1998 and Irish Guidelines add a practical consideration: supply substitutes will be included in the relevant market only if the units of output are sufficiently homogeneous to be meaningfully brought into market share calculations.[36] Otherwise, supply responses will be considered elsewhere in the analysis.

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The UK Authorities also include supply substitutes in the relevant market if there are similar products and/or operating in adjacent areas.

1.39 In sum, while there is a broad consensus on the importance of supply substitutes to market definition, the Guidelines differ concerning at what stage in the market power analysis it is to be utilized: the market definition stage, as part of the entry analysis, or in the assessment of competitive effects.

1.40 For example, the U.S. Guidelines generally define relevant markets only on the basis of demand-side factors. Where producers can virtually instantaneously and costlessly switch production, markets under the U.S. Guidelines may, for convenience, include supply side substitutes. Otherwise, consideration of supply-side factors is generally given only at subsequent stages of the process when additional market participants or credible entrants are identified. Several advantages, e.g., a clearer understanding of market power and more "sensible" market shares, are said to result from not including supply substitutability as part of market definition.[37] In any event, the factual question of whether a firm or firms on the supply side will respond to a price increase depends upon a complex set of issues, i.e., production capability and flexibility, contractual commitments to (and customer relations with) current customers, margins on current products, etc. Also, because of these often complex issues, determining demand-side substitutability is generally (though not always) less difficult than determining supply-side substitutability. The U.S. Guidelines seem to imply that it is more efficient to complete the demand-side task and then take account of the (normally) more complex and time-consuming questions presented by the supply side.

1.41 In any event, there are probably very few cases in which the calculation of market share(s) under the U.S. approach will differ from the calculation under the approach that includes supply-side responses in market definition.[38] This is because the U.S. guidelines provide for the inclusion in the market share calculation of all market "participants," which includes firms not currently producing the product if they are "uncommitted entrants." These are firms whose supply response to a price increase in the products of the merging firms would likely occur within one year "without the expenditure of significant sunk costs…."[39]

1.42 Also, even those Guidelines that include supply responses in market definition exclude products of potential suppliers at the market definition stage if substantial time or investment impediments exist. Most of those Guidelines then consider these suppliers in the assessment of whether their entry into the relevant market would counter the creation or exercise of market power. The Australian, Brazilian, Canadian, EC, Finnish, and U.K. Guidelines consider whether switching to the production of the relevant product requires significant new investment or a significant amount of time (typically more than a year). Some of these Guidelines refer to the considerable investment required, for example, by the construction or adaptation of facilities, research and development, and significant impediments related to technology, marketing, and distribution.

1.43 As noted above, in Ireland, producers of supply substitutes that exercise an immediate competitive constraint but whose units of output cannot meaningfully be added into market share calculations are considered at the competitive effects stage. Supply-side factors that exercise a longer-term competitive constraint are considered as entry effects.[40]

1.44 In any event, the choice of which stage to consider supply-side substitutability should not change the outcome on the market power issue:

> Some competition authorities prefer to define markets solely on the demand-side, leaving supply-side issues to the analysis of new entry. In practice both approaches should produce the same conclusions on the question of market power, provided that supply-side issues are examined at some point...Defining markets on the supply-side can allow early determination that an undertaking has no market power, thus avoiding the need for further analysis.[41]

Perhaps the optimum guideline on supply-side substitutability would be early consideration of supply responses that would be immediate (or nearly so) and with no or little investment. This would allow for early resolution of cases where supply side substitutability alone answers the market definition (and market power) question. In all other cases, the supply side would be considered later in the process, i.e., after the market is defined on a demand side basis only.

III. GEOGRAPHIC MARKET DEFINITION

1.45 The geographic market definition process starts with the identification of the geographic area where the merging parties offer the overlapping product and seeks to identify other areas from which customers could purchase these products should the sellers raise prices post-transaction. The language of the Australian Guidelines is typical of most Guidelines:

> Starting with the geographic area supplied by the merged firm, each geographic market is gradually expanded to incorporate sources of supply to which consumers would turn and firms which supply, or would supply, the relevant product into that area in the event of a significant price rise.[42]

1.46 As with both the demand and supply dimensions of product market definition, the SSNIP test plays a key role in the demand and supply dimensions of geographic market definition. Customers are asked if they would look outside the hypothetical geographic market if prices within that market rose and suppliers outside of the market are asked if they would sell into it if prices rose. This iterative process is completed and the geographic market defined when the hypothetical monopolist in an area can raise prices profitably without too many customers looking beyond that area or without too many out-of-area suppliers entering that area in response. In some cases, because of the availability of shipments and transportation cost data (particularly if that data is available over a period of changing economic conditions), the SSNIP test may operate with less friction in the geographic dimension than in the product market dimension.

1.47 Some of the Guidelines refer generally to the test of applying a hypothetical price increase to define geographic boundaries:

> The Commission will seek to define the geographical extent of a market to include all of the relevant, spatially dispersed, sources of supply to which buyers can turn should the prices of local sources of supply be raised.[43]

Others are more specific in their reference to the SSNIP test:

> The Authority delineates the geographic market for each relevant product, to be a region where a hypothetical monopolist of the product in the region could profitably impose a small but significant and non-transitory increase in price, holding constant the conditions of sale for all products produced elsewhere.[44]

1.48 Indeed, eight of the Guidelines (Finland, Germany, Japan and Romania excepted) refer to the SSNIP test. One of the Guidelines notes at the outset a relationship between the value of the product and the dimension of the geographic market:

> Generally, the higher the value of the product to be purchased, in absolute terms or relative to total buyer expenditure as appropriate, the more likely are buyers to travel and shop around for the best buy, and the wider the geographic extent of the market is likely to be.[45]

1.49 While most Guidelines contemplate the possibility of local (i.e., "infra-national") markets, only five of the Guidelines expressly refer to the possibility of an international market.[46] Other Guidelines do not seem to exclude the consideration of foreign competition[47] but indicate that it will be taken into account as part of the competitive assessment rather than at the market definition stage.[48] This would seem to complicate the analysis unduly, especially the calculation of market share. Moreover, it would seem more sensible for enforcement agencies and courts to adopt (as a "best practice" perhaps) a presumption that national boarders are not relevant when determining the boundaries of an economically sensible geographic market.

1.50 Some Guidelines refer to qualitative factors to assist in defining the relevant geographic market. For example, the EC and Romanian Guidelines refer to an area where the conditions of competition are "sufficiently homogeneous." The EC takes particular note of the process of market integration in the Union and the need to recognize artificial national barriers to trade that are in the process of being dismantled and thus may affect the scope of the geographic market going forward.[49]

IV. VERTICAL INTEGRATION, THE TEMPORAL DIMENSION, AND OTHER ISSUES

1.51 The Australian Guidelines explicitly add a so-called functional dimension to market definition:

> Delineation of the relevant functional market requires identification of the vertical stages of production and/or substitution which comprise the relevant arena of competition. This involves consideration of both the efficiencies of vertical integration, commercial reality and substitution possibilities at adjacent vertical stages. [50]

The purpose of this unusual feature is apparently to consider whether products produced or sold at several levels by vertically integrated firms, or by firms at another level of distribution than the merging firms, should be included in the relevant market because the exercise of market power at one stage of distribution can be constrained by firms at an adjacent level of distribution. Several other Guidelines (New Zealand, U.K.) discuss vertical integration in the market definition context but in more general terms, e.g., the U.K. (CC) Guidelines state that "conditions in downstream and upstream markets may affect the assessment of demand-and-supply-side substitution ..."[51]

1.52 Transactions involving vertically integrated firms raise the issue of whether production of a relevant product consumed internally by a market participant ("captive production") should be considered in the product market or whether only production sold to the "merchant market" should be included. The Guidelines that refer to this issue generally follow the principle that captive capacity or production will be included in the market only if it can be demonstrated that it would be profitable for the supplier to forego captive use and sell into the merchant market in response to a SSNIP of the product in the merchant market. For example, the U.K. (OFT) Draft Guidelines note that "The OFT may take into account captive capacity or production where that capacity or production could be readily and profitably switched to the free market."[52] Under the U.S. Guidelines, the products of vertically integrated firms are included in the relevant market "to the extent that such inclusion accurately reflects their competitive significance in the relevant market prior to the merger." This standard would seem to leave the issue open to development on a case by case basis.[53]

1.53 The U.K. (OFT) Guidelines 1998 offer a third dimension for market definition (in addition to product and geographic markets)—the temporal market, i.e., peak and off-peak services and seasonal variations in products.[54] The temporal factor may narrow the market definition by, for example, excluding off-peak rail tickets from the market where they are not viewed as substitutes for peak rail tickets by customers. While the U.K. (OFT) Guidelines 1998 explicitly set out this factor, it seems to be implicit in most Guidelines of the other jurisdictions that consider demand-side substitutability.

Price Discrimination

1.54 As noted previously, seven Guidelines reserve the possibility of defining markets of a subset of customers who are "captive" in the sense that, unlike others, they would not, or could not economically, switch to another product or to a supplier outside of a geographic area in response to a price increase.[55] Price discrimination (used here in its economic sense) can occur in both the product dimension (e.g., business travelers with a high value on certain departure and arrival times) and in a geographic dimension (e.g., customers without access to modes of transportation available to others). This concept of price discrimination is variously treated in the Guidelines that address it. For example, the Finnish Guidelines do not refer to the term "price discrimination" but do contemplate that "separate markets" may exist where certain customers must pay higher prices than others:

> The difference between various groups of customers and the differences between the prices of goods can have a bearing on the market definition. There can be separate markets, for example, if the goods are clearly sold at

different prices and on different conditions to different groups of customers, even though the physical characteristics and the intended use of the goods would indicate that they belong to the same market.[56]

Other Guidelines refer to "targeted" or "captive" customers to whom the relevant product is sold at higher prices because of the ability of sellers to price discriminate against them.[57] Price discrimination would seem an important (even outcome-determinative) concept in some cases and its absence from some Guidelines, while not necessarily indicating it is not a feature of market analysis in those jurisdictions, is notable.

1.55 It might also be noted that the ability of a firm to price discriminate among its customers, i.e., to charge customers according to how they individually or as members of sub-sets of customers, value the firm's product, can also be evidence of market power, especially with respect to those customers paying relatively more for the product than other customers.

Chains of Substitution

1.56 Three of the Guidelines discuss "chains" or "links" of products or geographic areas that may in combination constitute a relevant market under certain conditions despite the fact that they are not direct substitutes.[58]

1.57 The U.K. Guidelines take as an example the automobile market where a relatively inexpensive small car may not be viewed as a close substitute for a large luxury car (at least not according to a SSNIP test) but where nonetheless both cars may be in the same relevant product market.[59] This is because there are many models in between the two models at the opposite ends of the quality spectrum, and a rise in price of the most inexpensive small car might affect the demand and supply of cars adjacent to it in size and price, which will in turn affect conditions in cars adjacent to them, and so on until the "ripple" effect extends over the entire car market. This concept may also be helpful in service markets (e.g., ocean cruises where the cheapest room is not seen as a close substitute in a market definition sense for the most expensive stateroom but where they are in fact linked in a continuous chain of price and quality). In any event, most Guidelines do not address this important concept.

1.58 In the geographic dimension, one can think of a series of petrol stations strung out along a highway. The stations at the opposite end of the road may not be substitutes for most drivers but the pricing at each may be affected by the others. This is because the pricing at each station affects the price at the next closest station, which in turn affects its closest station, until a "chain" effect is established that may, as an economic matter, place all the stations on the highway in the same relevant geographic market.

V. HOW TRANSPARENT ARE THE GUIDELINES?

1.59 The Guidelines give valuable guidance to merging companies in defining markets. While some are quite general and others very detailed, they all describe generally the underlying principles and criteria for market definition and provide a list of factors and evidence that the authorities will rely on in defining the relevant market. Some Guidelines also summarize the process of defining markets. Some Guidelines do not provide guidance on the process and presumably defer to the agencies, courts, and practitioners to apply the principles on a case-by-case basis.

1.60 Case-law is cited in three of the Guidelines. The Australian and New Zealand Guidelines contain frequent citations and quotations from cases that support certain propositions. This reference to case law guides the reader to important cases on market definition and sometimes quotes the language from the decision. The Japanese Guidelines provide many illustrative examples of past cases involving market definition in a wide variety of industries. This approach can be useful as it offers the benefit of practical examples. Other Guidelines (e.g., the EC and the U.S.) seek to identify core issues and basic criteria in a shorter format without frequent examples or citations of case law. This approach has the advantage of emphasizing core legal and economic principles to be applied in all cases.[60] The two most recent draft Guidelines (Ireland and the U.K. (CC) Guidelines) focus on core principles and do not cite case-law.

1.61 A balance needs to be struck, it seems, between guidelines that contain a limited number of well-defined but broadly applicable principles and those that are so detailed as to carry the potential to confuse the reader or to appear to reflect inflexibility in dealing with what can be enormously complex and varied circumstances. In all cases, scope must remain for additional learning about how real-life markets operate and how they can be defined, measured, and understood by competition enforcement authorities, by the courts, and by lawyers and economists advising clients.

VI. POST-SCRIPT

1.62 Since the initial preparation of this chapter in the Spring of 2003, we are aware of two significant additions/updates to merger guidelines in the jurisdictions considered here. In the U.K., the Office of Fair Trade released Mergers -- Substantive Assessment Guidance ("OFT Guidance") in May 2003. Also, the European Commission published Guidelines on the Assessment of Horizontal Mergers Under the Council Regulation on the Control of Concentrations Between Undertakings ("EC Horizontal Guidelines") in February 2004.

1.63 Neither document considers market definition in detail. The OFT Guidance provides a brief discussion of market definition, but refers the reader to the U.K. (OFT) Guidelines 1998 for more detail. The EC Horizontal Guidelines mention market definition as a prerequisite to analyzing competitive effects and references the Commission's Notice on the Definition of the Relevant Market for the Purposes of Community Competition Law.

VII. CHART

1.64 A chart describing the key elements of each jurisdiction's approach to market definition is attached as Exhibit 1.

[1] The authors of this Chapter are Mark Leddy, Stéphanie Hallouët, and Michael Kehoe (Cleary, Gottlieb, Steen & Hamilton), Mauro Grinberg and Priscila Benelli Walker (Araujo e Policastro), and Javier Ruiz Calzado and Annukka Ojala (Latham & Watkins).

[2] Australia, Brazil, Canada, Finland, Ireland, Japan, New Zealand, the United Kingdom, and the United States address market definition as part of general guidelines on merger control, whereas the European Commission and Romania have issued specific guidelines on the definition of the relevant market in both non-merger and merger cases. The 'Principles of Interpretation' issued by the German authorities do not include detailed discussion of market definition. For the U.K., three sets of Guidelines were considered: the 1998 Market Definition Guidelines issued by the OFT, the draft guidelines consultation paper issued by the OFT in October 2002, and the Competition Commission guidelines issued in March 2003. These guidelines are referred to as the "U.K. (OFT) Guidelines 1998", the "U.K. (OFT) Draft Guidelines" and the "U.K. (CC) Guidelines", respectively.

[3] It is understood that in technical economic terms, all firms, other than in a perfectly competitive market, have some degree of "market power." The term is used here, however, as it is often used in merger analysis, i.e., to mean the ability of a firm or firms post-transaction to reduce competition whether unilaterally or through coordinated interaction.

[4] The residual demand curve measures the elasticity of demand faced by the merged firm after all of its competitors' sales of the product in question have been taken into account, i.e., it demonstrates whether the merged firm can profitably increase prices to its customers.

[5] "It is only because we lack confidence in our ability to measure elasticities, or perhaps because we do not think of adopting so explicitly economic an approach, that we have to define markets instead." Richard A. Posner, ANTITRUST LAW: AN ECONOMIC PERSPECTIVE (1976), at 125.

[6] See, e.g., *FTC v. Staples, Inc*. 970 F. Supp. 1066 (D.D.C. 1997), where the court concluded that the transaction would likely lead to higher prices in significant part because the internal pricing data of the parties demonstrated that prices were lower in cities in which Staples and Office Depot competed than in cities where they did not.

[7] In 1950, an amendment to the statute, among other things, added the language "in any line of commerce in any section of the country."

[8] See *United States v. Columbia Steel Co.*, 334 U.S. 496 (1948).

[9] In 1974, the U.S. Supreme Court held in *Marine Bancorporation* that "determination of the relevant product and geographic markets is a 'necessary predicate'" in merger cases. 418 U.S. at 618.

[10] Report of the Task Force on Productivity and Competition, reprinted in 1 J. REPRINTS FOR ANTITRUST L. & ECON. 827 (1969).

[11] In the 1960s and 1970s, the federal antitrust agencies and the courts were criticized by, among others, proponents of the so-called Chicago School for "gerrymandering" markets to block transactions in an alleged campaign against corporate "bigness." The term "gerrymandering" refers to efforts by politicians to configure election districts to ensure that their party continues to hold the legislative seats for those areas.

[12] Donald F. Turner, *The Role of the "Market Concept" in Antitrust Law*, 49 ANTITRUST L. J. 1145, 1150 (1980)

[13] "[A] proper definition of the relevant market is a necessary precondition for any assessment of the effect of a concentration on competition.", European Court of Justice, Joined Cases C-68/94 and C-30/95, *France and Others vs. Commission*, 1988 ECR I-1375, para. 143.

[14] "Market definition is a tool to identify and define the boundaries of competition between firms. It serves to establish the framework within which competition policy is applied by the Commission." (I.2) (In addition, the EU Competition Commissioner stated in 2001 that market definition is "a cornerstone of competition policy, but not the entire building...a tool for the competitive assessment, not a substitute for it.") The U.K. (OFT) Draft Guidelines indicate that "market definition is not an end in itself. It is a framework for analysing the direct competitive pressures faced by the merged firm." (3.12). The Australia Guidelines recognize that because market definition is subordinate to the goal of evaluating competitive effects, it is not a rigid exercise: "[T]he linking together of the process of definition of the market and its object implies some flexibility in the former."(5.36).

[15] Irish Guidelines at 2.2.

[16] In *FTC v. Staples, Inc*. 970 F. Supp. 1066 (D.D.C. 1997) the Court relied on direct pricing evidence to demonstrate that an office supply superstore was likely to maintain higher prices where it faced less competition from other office supply superstores even where functionally equivalent products were available from a variety of other retailers.

[17] Australia, Canada, Ireland, Japan, New Zealand, the U.K., and the U.S. use the SLC test and the EC, Finland, Germany, and Romania test for dominance. Brazilian competition law contains tests for both dominance and lessening or restriction of competition.

[18] See Carl Shapiro, *Mergers With Differentiated Products*, ANTITRUST (Spring 1996).

[19] Australian, Brazilian, Canadian, the EC, Irish, U.K. and U.S. Guidelines.

[20] Brazilian, Canadian, the EC, Irish, U.K. and U.S. Guidelines.

[21] Australian, the EC and U.K. Guidelines.

[22] Australian, Canadian, EC, Finnish, New Zealand, U.K., and U.S. Guidelines.

[23] The Finnish, Japanese and Romanian Guidelines do not mention the SSNIP test as an analytical tool to measure substitution. As noted above, the German 'Principles of Interpretation' do not include detailed discussion of market definition.

[24] Canadian Guidelines at 3.1.

[25] See Michael L. Katz and Carl Shapiro, *Critical Loss: Let's Tell the Whole Story*, ANTITRUST (Spring 2003).

[26] Id.

[27] Australia, Canada, the EC, Ireland, New Zealand, the U.K. and the U.S.

[28] For example, "[T]he price to take into account will be the prevailing market price." EC Guidelines at II.19.

[29] The EC Guidelines state, for example, that the prevailing market price might not be appropriate "where the prevailing price has been determined in the absence of sufficient competition". EC Guidelines at II.19. The New Zealand Guidelines state, "Where the Commission considers that prices in a given market are significantly

different from competitive levels, it may be necessary for it to assess the effect of a *ssnip* imposed upon competitive price levels, rather than upon actual prices, in order to detect relevant substitutes." New Zealand Guidelines at 3.6 fn. 23.

30 *United States v. E.I. duPont de Nemours & Co*. 351 U.S. 377 (1956).

31 Australia, Ireland, the U.K. (OFT) Guidelines 1998, and the U.S.

32 "By using the likely future price absent the merger as the relevant base price, the market is defined in a way which is relevant to the conduct at issue, by identifying and including the closest substitutes to the merging firms product(s)." Australian Guidelines at 5.44 fn. 38.

33 See Competitive Impact Statement for *United States v. Vail Resorts, Inc., Ralston Resorts, Inc., and Ralston Foods, Inc.* available at <http://www.usdoj.gov/atr/cases/f1000/1014.htm> ("It was estimated that, if the merger were allowed to take place without any divestiture, there would be an overall average increase in Front Range discounted lift ticket prices on the order of 4%, or about $1 per lift ticket on average to all Front Range customers, with higher price increases at the merging firms' resorts.")

34 The U.K. (OFT) Guidelines 1998 (and EC) uses the paper manufacturing industry as an example of the utility of supply-side substitutability in defining markets. While different types of paper are not demand side substitutes (bond paper vs. copier-grade paper), both are made on the same machines in the same process. The machine can fairly easily and without significant expense be switched from producing one to producing the other. Thus, bond paper and copier paper should be in the same product market.

35 The Japanese Guidelines do not distinguish between supply-side substitutability and market entry but merely list as criteria for market definition some factors that are generally used to identify supply substitution.

36 Irish Guidelines at 2.10; U.K. (OFT) Guidelines 1998 at 3.21.

37 Gregory J. Werden, *Market delineation Under the Merger Guidelines: a tenth anniversary retrospective*, THE ANTITRUST BULLETIN (Fall 1993).

38 Id. at 525.

39 Firms that could respond but would require more time or significant sunk costs ("committed entrants") are considered in the entry analysis, U.S. Guidelines at 1.32.

40 Irish Guidelines at 2.10.

41 U.K. (OFT) Guidelines, 1998 at 3.18.

42 Australian Guidelines at 5.61.

43 New Zealand Guidelines at 3.3.

44 Irish Guidelines at 2.7.

45 New Zealand Guidelines at 3.3.

46 Australian, Canadian, EC, U.K. (CC) Guidelines, and U.S. Guidelines. The Romanian Guidelines also seem implicitly to consider this possibility, although it is not clear whether they are merely stating a hypothetical future development: "[T]he progress in the field of transports and communications and the tendencies of abolishing the barriers and of liberalising the international trade may alter, in time, the limits of the relevant geographic market, going beyond the borders of a country."

47 Although this is not clear in the Japanese Guidelines at 10: "Even if the business area of company extends to foreign countries, the competition to be maintained…is

domestic competition in Japan. Therefore, the main focus of examination will be on the scope of business activities of domestic traders."

48 New Zealand Guidelines at 20: "the Commission, in order to comply with the wording of the Act, is likely to define a national market and then...to consider the extent to which overseas suppliers exercise a competitive constraint on the participants in the domestic market." We understand that this is also the approach of the German authorities ("normative" market vs. "economic" market).

49 EC Guidelines at 32: "A situation where national markets have been artificially isolated from each other because of the existence of legislative barriers that have now been removed will generally lead to a cautious assessment of past evidence regarding prices, market shares or trade patterns."

50 Australian Guidelines at 5.64. The Guidelines note that, for example, a single functional market for the distribution of groceries to the public was defined, reflecting the constraint imposed on the conduct of independent wholesalers by downstream competition between their independent retail customers and the vertically integrated chains. The New Zealand Guidelines also add a functional level (See 3.4).

51 U.K. (CC) Guidelines at 2.35.

52 U.K. (OFT) Draft Guidelines at 3.22.

53 U.S. Guidelines at 1.31.

54 U.K. (OFT) Guidelines 1998 at 5.

55 Australian, Canadian, EC, Finnish, New Zealand, U.K., and U.S. Guidelines.

56 Finnish Guidelines.

57 U.S. Guidelines at 1.12 (product market) and 1.22 (geographic market) ("targeted"); U.K. (OFT) Guidelines 1998 at 3.7 ("captive").

58 U.K. (OFT) Guidelines 1998 at 3.9; Australian Guidelines at 5.55; EC Guidelines at 57-58.

59 U.K. (OFT) Guidelines 1998, at 3.9-3.10.

60 See also W. Blumenthal, *Clear Agency Guidelines: Lessons from 198*2, 68 ANTITRUST L.J. 5 (2000).

CHAPTER 3 - UNILATERAL EFFECTS[1]

OVERVIEW

This Chapter examines the types of horizontal unilateral effects identified in the guidelines, analyses the use of safe-harbours, describes an emerging seven-strand approach for the appraisal of horizontal mergers falling outside any strong safe-harbours, and discusses the estimation of market shares and market concentration. The Chapter also identifies the grounds on which guidelines tend to contemplate prohibition of vertical or conglomerate mergers.

I. INTRODUCTION

1.1 Unilateral effects arise when the merged group is able profitably to reduce value for money,[2] choice or innovation[3] through its own acts without the need for a co-operative response from competitors.[4] This Chapter examines the treatment of horizontal unilateral effects (i.e. unilateral effects arising when the merger occurs between companies actually or potentially active in the same economic market) and vertical and conglomerate unilateral effects (both of which involve the leveraging of market power from one market into a second; in the case of vertical effects those markets are vertically connected, and in the case of conglomerate effects they are not). In analysing horizontal unilateral effects, the opening parts of this Chapter examine: the types of unilateral effects identified in the guidelines; the use of safe-harbours within which mergers are immune from challenge or are presumed unlikely to be challenged; the methodology in cases falling outside any safe-harbours; and the approach of antitrust authorities to the estimation of market shares and market concentration.

1.2 Although the term "unilateral effects" is widely adopted, its use is not universal. In particular, the UK OFT Guidelines and the European Commission Guidelines use the term "non-coordinated effects" in place of "unilateral effects" to emphasise that the issue in unilateral effects analysis is not simply whether the merged group will increase its prices following the transaction, but also whether other firms will find it profitable to raise their prices (because the higher prices of the merged group's products will cause some customers to want to switch to rival products thereby increasing rivals' demand).[5]

II. THE TYPES OF HORIZONTAL UNILATERAL EFFECTS IDENTIFIED IN THE GUIDELINES

2.1 Most of the merger guidelines which have been surveyed provide that mergers will be challenged if they are likely to result in unilateral effects (although they vary in the types of unilateral effects identified).

(a) Market shares as a prima facie indicator of likely unilateral effects

2.2 The New Zealand Guidelines are reflective of a reasonable consensus in stating: "The greater the aggregation of market shares in the hands of parties to an acquisition, the greater the likelihood that the acquisition would lead to" competition concerns.[6] However, the guidelines generally[7] indicate that an analysis of market shares is not in itself determinative of whether unilateral effects will arise as a result of a transaction, and it is necessary also to carry out a broader examination of the way in which the market operates in the light of the factors detailed in section IV below.

(b) Differentiated products and capacity constraints

2.3 In cases involving the merger of smaller market participants in an oligopolistic market, the analysis of possible unilateral effects is more complex. Decisions to intervene in a merger on such grounds may also be more controversial, since potentially significant competitors will remain in the market following the merger. In these circumstances, the concern of the antitrust authorities is that the merger will eliminate a particularly important competitive constraint on the merging parties, creating an incentive for the merged group to raise its prices, and that it will potentially reduce competitive restraints on other competitors. Such unilateral effects may arise through a variety of mechanisms, but the guidelines surveyed which discuss unilateral effects in detail tend to focus in particular on two circumstances.[8]

2.4 First, mergers of suppliers of close substitutes in markets for differentiated products (i.e. products which consumers perceive to have different attributes from rival products). One important part of an examination of such issues is to assess whether the competition between the two parties has been important and would be unlikely to be replaced. The guidelines surveyed tended to identify as factors relevant for consideration:

(a) whether the merging parties' products are particularly close substitutes for one another, in terms of their product attributes, geographic location, or perceived quality or reliability;

(b) whether the products supplied by rivals are close substitutes for the products supplied by the merging parties;

(c) whether actual rival suppliers would have the incentive and ability to re-position their products as closer substitutes for the merged group's products following the transaction and whether potential rival suppliers would have the incentive and ability to enter the market as suppliers of close substitutes for the merged group's products; and

(d) whether the merger results in efficiency gains of a magnitude which creates an incentive on the merged group to increase output (thereby reducing price).

2.5 Secondly, unilateral effects may arise in cases when the merging parties' rivals face important capacity constraints.[9] The merger may enable the merged group profitably to reduce output, leading to increases in prices if entry or expansion would not be likely and sufficient to counteract any attempt by the merged group to implement such a strategy.

2.6 In such cases (involving product differentiation or capacity constraints), the value of market shares and measures of market concentration in predicting harm may be limited. In the context of differentiated products, market definition may become a more subjective exercise: any market may exclude products which are "close" substitutes or include products which are more "distant" substitutes. In particular, there is a concern that focusing on market shares can lead antitrust authorities into the "0/1 fallacy" under which all goods or services which are included in the market are treated as being of equal weight (as all count equally in the calculation of market shares) whereas all goods or services which are excluded from the market are treated as having no weight (as they do not count in the calculation of market shares).

(c) Scope for applying unilateral effects analysis

2.7 Unilateral effects analysis is most commonly applied in mergers involving existing competitors. In addition, some of the guidelines provide that unilateral effects analysis may also be applied:[10]

(a) in transactions involving acquisitions of potential, rather than existing, competitors; and

(b) in transactions which create or strengthen market power on a procurement market (i.e. transactions raising concerns about monopsony, as opposed to monopoly, power).[11]

III. THE USE OF SAFE-HARBOURS

3.1 Any antitrust authority must determine whether there are certain categories of merger which are presumed not to raise substantive concerns and therefore merit clearance without the need for an in-depth analysis of the market and the effects of the transaction. There are three possible approaches. First, a "strong safe-harbour" arises when an antitrust authority adopts an absolute rule that transactions falling below certain thresholds will not be prohibited.[12] Secondly, a "weak safe-harbour" arises when there is a presumption that transactions falling below certain thresholds will not be prohibited, but the presumption may be rebutted.[13] Thirdly, several antitrust authorities make no use of safe-harbours.[14]

3.2 Safe-harbours are invariably constructed around market shares, the Herfindahl-Hirschmann ("HHI") concentration index,[15] or concentration ratios (e.g. CR4, which measures the proportion of the market which is supplied by the largest four companies). Safe-harbours may be set at a higher level in relatively smaller economies which are more prone to concentration.[16]

3.3 It is instructive to consider whether safe-harbours are advisable. Their benefits include conserving the resources of the authority for use in cases which are more likely to result in widespread and substantial consumer harm, reducing the notifying parties' costs, and increasing predictability in the merger control process. Further, it is impossible for antitrust authorities to predict the effects of mergers with certainty (suggesting that a very detailed appraisal of a merger may be no more reliable than a more simplistic approach using rules which are fairly simple and straightforward to administer). However, we are sceptical about the use of strong safe-harbours, conferring an absolute immunity from challenge, for two reasons. First, the safe-harbours we have identified have been based on market share or concentration data, both of which depend crucially on market definition, which is not an exact science and sometimes raises very difficult issues. The difficulty in granting an immunity based on market shares or concentration ratios is that an error in market definition cannot be remedied at the stage of appraising the merits of the case because the effect of granting an immunity is to remove the need for a detailed appraisal. Errors in market definition may therefore result in serious harm to consumers.[17] Secondly, the granting of an immunity from challenge deprives the antitrust authority of an opportunity properly to investigate issues which may cause substantial harm to consumer welfare. For example, as noted above, a merger between suppliers of differentiated products may result in substantial increases in price even if the merged group has relatively low market shares. It follows in our view that market shares and concentration ratios are not wholly reliable indicators of the competitive effects of a transaction and they are better used as indicators of the authority's likely response (i.e. as a weak safe-harbour) rather than as a source of immunity (i.e. a strong safe-harbour).[18]

IV. METHODOLOGY IN CASES FALLING OUTSIDE ANY STRONG SAFE-HARBOURS

4.1 In examining the treatment by the guidelines surveyed of unilateral effects in cases falling outside any strong safe-harbours, we detected, to an extent, an emerging consensus around the use of seven common "strands". The ordering of the seven strands is not significant, except that the guidelines tend to contemplate that market definition is the first step in the analysis. Indeed, the remaining strands are generally considered together and in fact overlap.

4.2 The first strand is to define the relevant product and geographic markets. This issue is addressed in Chapter 1.

4.3 The second strand of the analysis involves assessing the positions of the merging parties in such markets. In examining this issue, the guidelines tend to focus on the market share of the combined group, the increment in market share arising from the transaction, and the difference between the market share of the combined group and its next-largest competitor.[19] The German Guidelines identify a rebuttable presumption of anti-competitive harm arising from the merger if the post-merger market share exceeds 33 per cent.[20] In addition, the German Guidelines[21] provide that economies of scale or scope, product "range", privileged access to facilities, technologies or suppliers, financial or brand strength, and distributional advantages are all factors that may indicate that the merged group will hold a "paramount market position" and thus make a merger subject to challenge. As part of an examination of the positions of the merging parties, some of the guidelines also indicate that the authorities will consider whether qualifying efficiency gains will eliminate, or reduce the extent of, the merged group's incentive to raise prices. This issue is discussed separately in Chapter 5.

4.4 The third strand involves analysing the positions of competitors to the merged group. It is necessary to consider whether the competitors will be effective to prevent the merged group from raising price, which depends in particular on the extent to which competitors' products are regarded by consumers as substitutes for the merging parties', whether there are any constraints on substitution and the ability of competitors to expand output or reposition their products to win business from the merged group.

4.5 The fourth strand is to examine market dynamics. For example, markets in which contracts are awarded through competitive tenders may[22] be highly competitive, even if there are relatively few suppliers competing for the business.

4.6 The fifth strand involves examining new entry. Our review of the guidelines suggested that there is reasonable consensus that possible new entry ought to be taken into account as a factor pointing towards approving a transaction if the entry would be likely, timely and sufficient in magnitude and scope to counteract the anti-competitive effects which would otherwise result from the merger.[23] The principle underlying the consensus is that if attempts by the merged group to exercise market power would be defeated by new entry into the market, then the transaction will not result in long-term detriments to consumer welfare and ought therefore to be approved. This issue is dealt with in detail in Chapter 4 and is not considered further in this Chapter.

4.7 The sixth strand is to examine the role of buyer power. The issue is whether the merged group's customers will be able to take steps which have the effect of preventing the merged group from profitably raising its prices.[24] This is not a function of whether the customers are "large". Indeed, in the absence of credible alternatives to the merged group or other sources of leverage, a customer, no matter how large, may not enjoy buyer power. Rather, the question of whether customers have buyer power depends on whether they can credibly threaten to take steps which render increases in price unprofitable. Such steps typically involve switching or threatening to switch to other suppliers or other products, sponsorship of new entry, starting own production, delaying purchases or refusing to buy other products of the supplier.

4.8 The seventh strand is to determine whether any antitrust concerns are caused by the merger. This issue is commonly addressed by identification of a "counter-factual".[25] This involves predicting the way in which the market would have operated if the merger did not occur. Commonly, the counter-factual will be the way in which the market operates prior to the merger. However, this is not inevitable, for example if suppliers are likely to enter or exit from the market if the merger does not occur. The counter-factual can then be compared with the predicted post-merger market operation. The differences between the two scenarios are caused by the merger.

4.9 Some guidelines contain "materiality" thresholds which must be crossed before a transaction may be prohibited on the grounds that it is likely to give rise to unilateral effects.[26] For example, the Canadian Guidelines include an explicit requirement that harmful effects are "substantial" before the government will intervene. Price increases will be considered "substantial" when "the price of the relevant product is likely to be materially greater, in a substantial part of the relevant market ... and where this price differential would not likely be eliminated within two years."[27]

4.10 The guidelines vary in the extent to which they state clearly that:

(a) unilateral effects may be a basis for challenging a merger involving potential, rather than current, competitors;

(b) unilateral effects may be a basis for challenging a merger that creates procurement power (i.e. raises concerns about monopsony, as opposed to monopoly, power); and

(c) a failing firm defence may apply.

The guidelines also vary in the extent to which they acknowledge that in markets for differentiated products, market shares may not accurately reflect the extent of market power and the extent to which the products of the merging firms are close substitutes.

V. THE ESTIMATION OF MARKET SHARES AND MARKET CONCENTRATION

5.1 This section examines the best way of estimating market shares and market concentration, after relevant product and geographic markets have been defined. (For a discussion of the definition of relevant markets, see Chapter 1.) This is important because pre- and post-merger market shares and/or measures of market concentration are estimated in the vast majority of merger cases, are used in applying safe-harbours, and are often used as an important step in the analysis of the merged group's market power. The way in which market shares are estimated may have as much practical impact on the data obtained as the definition of the relevant market. However, whilst the majority of the guidelines surveyed deal with market definition in detail, there is relatively little discussion of the proper means of estimating market shares and concentration ratios.

5.2 The estimation of market shares and market concentration raises five issues.

(a) What is the objective in estimating market shares or concentration ratios? (Once the objective is clear, it ought to be easier to choose between different options for the estimations.) The New Zealand Guidelines suggest that, other things being equal, when there is a choice of market share measurements, the criterion to be preferred is "the measure amongst those available that yields the highest level of market share for the combined entity."[28] An alternative view is that the objective of market share and concentration data is to provide the best initial indication of (respectively) the merged group's prospective market power (i.e. its ability following the transaction profitably to raise prices beyond the pre-merger prevailing level), the market power of competitors and the structure of the market, remembering that the information is no more than an indication and it is always necessary also to examine the other factors mentioned in section IV above in order to reach any concluded view on the way that the market operates.

(b) What criteria should be used to measure market share? A wide range of criteria is available including[29] value (particularly for differentiated goods[30]), volume (particularly for homogeneous products) and capacity (particularly for homogeneous products when customers can readily switch supplier and suppliers compete on the basis of output[31]), but also the numbers of credible bidders (bidding markets[32]), uncommitted reserves (for cases involving finite resources), installed base and firm orders (when incumbency affects future sales, e.g. supplies of expensive durable goods such as aircraft) and combinations of two or more of these criteria. There are suggestions in the guidelines that the choice of criterion for measuring market shares will depend on which provides the best indication of the merged group's market power (i.e. the best indicator of its future competitive significance[33]) given the theory of competitive harm which is being investigated and the characteristics of the market.

(c) What period should be used in calculating market shares? The consensus seems to be that a one year period is ordinarily appropriate, but that longer periods may be adopted in particular in the case of markets involving small numbers of transactions per year to ensure that the data are not distorted.[34]

(d) Should captive production (i.e. production for consumption within the group[35]) be included in the market share calculations?[36] There are three options. The first is to adopt a general rule excluding captive production on the grounds that companies engaged in self-supply are generally unwilling to sell in the market because doing so may leave unsatisfied internal demand and may require investment in distribution and marketing systems.[37] The second is to include such sales to the extent[38] that they would be diverted to third party sales in the event of a SSNIP.[39] The third is to include self-supply in the market to the extent that such inclusion accurately reflects its competitive significance (which might arise if captive production would be diverted to third party sales in the event of a SSNIP or if captive producers might influence market operation by increasing production both of the relevant product and the downstream output).

(e) What criteria should be used to estimate market concentration? The antitrust authorities whose guidelines have been surveyed invariably use HHI data or concentration ratios in estimating market concentration. HHI data arguably provides richer and less arbitrary information than concentration ratios, in particular providing information relating to the whole market (rather than just the largest firms), accounting for the relative sizes of the larger firms and avoiding arbitrariness (e.g. if CR4 is used then a merger between the fifth and sixth largest firms may result in no change in the index, whereas a merger between the fourth and tenth largest will do so).[40]

VI. VERTICAL AND CONGLOMERATE EFFECTS

(a) Introduction

6.1 This section considers the treatment of "vertical" and "conglomerate" effects in merger guidelines. Vertical mergers are those between undertakings operating at different functional levels of the supply chain, such as wholesale and retail (although one or more of the undertakings may, of course, operate at more than one such functional level). Conglomerate mergers are those between undertakings operating in different markets, when such markets are neither upstream nor downstream of one another.[41]

6.2 Many of the guidelines surveyed deal with vertical issues and some deal with conglomerate issues.

6.3 In general, the guidelines tend to recognise that the justification for intervening to prohibit vertical and conglomerate mergers is weaker than for horizontal mergers (because horizontal mergers generally[42] eliminate actual competition whereas vertical and conglomerate mergers do not).[43] For example, the UK Competition Commission Guidelines note that in general conglomerate mergers do not raise competition issues (whilst recognising several scenarios in which they could be problematic).[44] By contrast, the German Guidelines adopt a more conservative position, assuming, in the case of vertical mergers, that "foreclosure effects ... are likely, for example, when important competitors are dependent on the supply or demand from the vertically integrated undertaking".[45]

6.4 Further, several of the guidelines surveyed acknowledge that vertical mergers in particular may have benefits for consumers through efficiency gains, e.g. by reducing transaction costs, providing an assurance of supply of important inputs, preventing free riding, eliminating double marginalisation or eliminating market power.[46]

(b) Vertical issues

6.5 The guidelines focus on three main theories of harm which might arise from vertical integration through merger.[47]

(a) Vertical integration may result in upstream or downstream foreclosure in certain circumstances.[48] Upstream foreclosure arises if the merger is likely to result in the merged group refusing to supply an input or raising its rivals' costs by increasing the price of an input, and such conduct is likely to lead to a significant impediment to effective competition in the downstream market. Downstream foreclosure arises if it is likely that the merger will result in the merged group refusing to purchase an input from rival upstream suppliers or offering to purchase such an input only at lower prices, and such conduct is likely to lead to a significant impediment to effective competition in the upstream market. The question of whether a merger ought to be prohibited on these grounds is a difficult one which in our view would benefit from more detailed analysis and exposition than in the guidelines surveyed.

(b) Vertical integration may increase barriers to entry by requiring a new entrant to enter two markets rather than just one.[49] The US Non-Horizontal Guidelines limit the application of this theory to cases satisfying three criteria, namely that it is necessary for a new entrant wishing to enter the primary market also to enter the secondary market, the need to enter the secondary market makes entry into the primary market more difficult and less likely, and the structure and performance of the primary market is otherwise conducive to non-competitive performance.[50]

(c) Vertical integration may facilitate the avoidance of regulatory constraints. For example, the US Non-Horizontal Guidelines identify a concern that vertical mergers can create transfer pricing issues, and may be entered to avoid price controls.[51]

(c) Conglomerate issues

6.6 A wide range of conglomerate effects has been identified,[52] but the guidelines which have been surveyed and which identify potentially harmful conglomerate effects have tended to focus on portfolio power. This arises when the merged group has market power in at least one market but is also active in one or more other markets which are connected, for example because the products are sold or consumed together. Some guidelines[53] suggest that the combination of activities in neighbouring markets may itself be a source of market power (on the basis that the whole is worth more than the sum of the parts). However, there is widespread disagreement about whether it is advisable to prohibit mergers on the grounds of portfolio power. For example, the Irish guidelines state that "anti-competitive harm from portfolio effect is extremely unlikely" and identify a number of important limitations on the application of the theory.[54]

(d) Is there a relevant distinction between vertical and conglomerate issues?

6.7 The US Guidelines note that in some circumstances, the non-horizontal merger of a firm already in a market with a potential entrant to that market may adversely affect competition in the market. The guidelines comment that: "Under traditional usage, such a merger could be characterized as either 'vertical' or 'conglomerate,' but the label adds nothing to the analysis."[55] We agree with this analysis and have included mergers involving potential competitors in the discussion of "horizontal mergers" above. In the case of both vertical and conglomerate effects, the issue seems to us to be whether the merger creates an incentive and ability on the merged group to leverage market power from one market into a second market: on this view, the question whether those markets are vertically connected or not is relevant to an assessment of the merged group's incentives and abilities but not to the fundamental inquiry.

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1 Alistair Lindsay (partner, Allen & Overy, UK; author, "The EC Merger Regulation: Substantive Issues", Sweet & Maxwell, 2003), Larry Fullerton (partner, Sidley Austin Brown & Wood, LLP, USA) and Andrew Matthews (partner, Minter Ellison Rudd Watts, New Zealand). The co-authors are grateful to Mauro Grinberg (Araújo e Policastro Advogados, Brazil) for his comments on an earlier draft.

2 Value for money is a reflection of price and quality. In the remainder of this Chapter, we focus on the implications of the transaction for prices.

3 This Chapter examines the effects of mergers on consumer welfare (comprising value for money, choice and innovation), reflecting an emerging international consensus.

4 The guidelines which define unilateral effects do so in varying terms, but the gist of the definitions is that given in the text. (Co-ordinated effects are dealt with in Chapter 3.)

5 See the UK OFT Guidelines, para. 4.7 and the European Commission Guidelines, paras. 22(a) and 24. See also the Overview Paper, para. 25.

6 Section 5.2.

7 See, e.g., the Irish Guidelines, section 4.

8 See, e.g., the US Guidelines, section 2.2.

9 It should be noted that, even if competitors do *not* face capacity constraints, they may have an incentive not to expand output if the merged group seeks to increase prices (because competitors in such a situation may benefit from the increases in price resulting from the merged group's conduct).

See, e.g, the European Commission Guidelines, paras. 58 to 60 and paras. 61 to 63.

[11] Sellers in such markets may be potential entrants for the purposes of sub-para. (a) of the text.

[12] The Brazilian Guidelines, paras. 48 and 50, come *closest* to the use of a strong safe-harbour, in the sense that, although there are three exceptions to the general rule that mergers will be cleared if they result in a combined market share of below 20 per cent., those exceptions do not clearly relate to horizontal unilateral effects. See also the Romanian Guidelines, section 3.

[13] See, e.g., the Australian Guidelines, paras. 5.95 to 5.97 and the European Commission Guidelines, paras. 18, 19 and 20.

[14] See, e.g., the OFT Guidelines, para. 4.4.

[15] Calculated by summing the squares of the market shares held by the market participants.

[16] See the New Zealand Guidelines, section 5.3.

[17] Cf. the German Guidelines which contemplate the use of tolerance thresholds when there are uncertainties in market definition: see section B1.2. (In addition, it must be recognised that most jurisdictions with merger control also impose restrictions on anti-competitive conduct.)

[18] Notably, the revised New Zealand Guidelines (which were effective from 1 January, 2004) have moved away from a statement that acquisitions falling within the defined safe harbours are unlikely to breach the relevant provisions, save in exceptional circumstances to a weaker position that, while unlikely to contravene the provisions, the figures are indicative only and the New Zealand Commerce Commission reserves the right to intervene or decline clearance in instances of much lower market shares; see section 5.3.

[19] The calculation of market shares is discussed in section V of the text below.

[20] Section B1.1.1 (reflecting the German legislation).

[21] Sections B2 and B3.

[22] It does not follow that such markets *are* necessarily competitive, e.g. if the bidders do not have equivalent expertise / experience.

[23] The formulation originated in the US Guidelines, section 3.1. See also, e.g., the New Zealand Guidelines, section. 6.3.

[24] In this regard, it is important to examine the scope for suppliers to engage in price discrimination, charging higher prices to those customers which do not have buyer power.

[25] See, e.g., the UK OFT Guidelines, paras. 3.23 and 3.24.

[26] Commonly, such materiality thresholds are contained in national legislation.

[27] Canadian Guidelines, para 2.4. The Canadian authorities are currently consulting on proposed amended guidelines. The draft amended guidelines (see sections 2.12 and 2.13) retain the threshold mentioned in the text, but explain that the two year period runs from when the market power is likely to be exercised and not necessarily the time of the merger reference; they also stress that the material price increase benchmark is not a numerical threshold but rather is the subject of market specific analysis.

[28] Section 5.2

[29] See also the Canadian Guidelines, section 4.2.2 (use of output of firms within the market, adjusted to take account of exports and certain imports) (and the proposed amended Canadian Guidelines, section 4.9).

[30] See, e.g., the Japanese Guidelines, section 3.B(1)a.(b).

[31] See, e.g., the Australian Guidelines, para. 5.100.

[32] US Guidelines, fn. 15.

[33] US Guidelines, section 1.41.

[34] See, e.g., the Brazilian Guidelines, para. 49 and the German Guidelines, section B1.1.3.

[35] i.e. a company, its parent companies and subsidiaries of the companies and its parents.

[36] One issue which requires further analysis is the extent to which the treatment of captive production should be determined at the stage of market definition or, instead, as part of the subsequent analysis of the market.

[37] Arguably, such an approach involves an arbitrary disapplication of the SSNIP test in cases involving self-supply.

[38] Assessing the extent to which production would be converted to third party sales creates quite a challenge.

[39] A small but significant, non-transitory increase in price: see the discussion in Chapter 1. See the UK OFT Guidelines, para. 3.21.

However, calculation of HHIs may be very difficult when numerous suppliers are involved.

[41] Mergers which eliminate a potential entrant into a market are sometimes regarded as "conglomerate" mergers (see, e.g., the Canadian Guidelines, section 4.12 (and the proposed amended Canadian Guidelines section 11.1)) although this Chapter follows the majority in treating them as a category of horizontal mergers.

[42] The statement in the text is not true of mergers which eliminate potential competitors. (Such mergers have been treated as horizontal mergers for the purposes of this Chapter, although they are sometimes regarded as conglomerate transactions.)

[43] See, e.g., the Canadian Guidelines, sections 4.11 and 4.12 (and the proposed amended Canadian Guidelines sections 10.6, 10.7, 11.1 and 11.2). In addition, the circumstances in which vertical and conglomerate mergers may harm consumer welfare are more limited and less well understood than those relating to horizontal mergers.

[44] Para. 3.69.

[45] Para. B3.1.

[46] See, e.g., the New Zealand Guidelines, section 10.1.

[47] Vertical mergers may also harm consumer welfare in particular by facilitating tacit co-ordination (see Chapter 3), facilitating price discrimination, providing access to confidential information held by the target company or facilitating cross-subsidisation.

[48] See, e.g., the Japanese Guidelines, section 3.B.(2)d.

[49] See, e.g., the Canadian Guidelines, section 4.11.1 (and the proposed amended Canadian Guidelines section 10.2).

[50] Section 4.2.1.

[51] Section 4.2.3.

[52] e.g. conglomerate issues may be said to arise from full-line forcing, cross-subsidisation, predatory pricing or control of information.

[53] See, e.g., the German Guidelines, section B3.2.
[54] Section 6.7.
[55] Fn. 26.

CHAPTER 4 - COORDINATED EFFECTS ANALYSIS UNDER INTERNATIONAL MERGER REGIMES[1]

OVERVIEW

A merger, joint venture or other concentration typically removes at least one independent seller from a relevant product and/or geographic market. Depending on the competitive strength of the departing firm, the number and incentives of the remaining firms in the market, and the environment in which those firms compete, a transaction may result in a new dynamic in the market – namely, the incentive for the remaining firms to coordinate their competitive behavior based on rational predictions about the reactions of the remaining rivals, rather than to compete vigorously. Competition law and regulatory agencies should exercise their discretion in such a way as to evaluate the likelihood that transactions will result in anticompetitive coordinated interaction, and act to prevent that result should available factual evidence and economic analysis demonstrate the likelihood it will occur. This paper examines the approach taken by the merger guidelines of twelve jurisdictions with regard to coordinated interaction and evaluates the underlying economic basis for determining when a merger will create such an effect.

I. INTRODUCTION

1. Competition law has long been concerned that the loss of a firm through a merger, joint venture or other concentration may facilitate coordination among the remaining firms in the industry, leading to reduced output, increased prices or diminished innovation. The analytical framework used by competition authorities has recognized this fundamental competitive effect in a variety of forms, treating it in some cases with detailed discussion and analysis and, in others, merely with passing notice. This study evaluates the treatment of coordinated effects in the

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regulatory framework of twelve jurisdictions[2] as expressed in their respective guidelines for analysis of horizontal mergers.[3]

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[2] The jurisdictions evaluated include Australia, Brazil, Canada, the European Commission, Germany, Ireland, Japan, New Zealand, Romania, the United Kingdom and the United States. The authors note that the merger guidelines of Finland were not evaluated due to the lack of an English translation of these guidelines relating to coordinated effects. It should also be noted that, at the time of this paper, the guidelines of the European Commission are still in the drafting stage. They have been subject to a public consultation and may be modified accordingly. Specific references to these guidelines are as follows:

Australian Competition and Consumer Commission, *Merger Guidelines*, *available generally* http://www.accc.gov.au/fs-pubs.htm (June 1999) (referred to herein as "Australian Guidelines").

Brazilian Secretariat for Economic Monitoring, *Guia para Análise Econômica de Atos de Concentração Horizontal*, *available generally* http://www.fazenda.gov.br/seae/ (Non-official English translation provided by Analytical Framework Subgroup, Exhibit, Concentration Act, Economic Analysis Form) (referred to herein as "Brazilian Guidelines").

Canadian Competition Bureau, *Merger Enforcement Guidelines*, http://strategis.ic.gc.ca/pics/ct/meg_full.pdf (Mar. 1991) (referred to herein as "Canadian Guidelines").

European Commission, *Guidelines on the Assessment of Horizontal Mergers Under the Council Regulation on the Control of Concentrations Between Undertakings* [2004] O.J. C31/5 (referred to herein as "EC Guidelines").

Bundeskartellamt, *Principles of Interpretation*, http://www.bundeskartellamt.de/Checkliste-E02.pdf (Oct. 2000) (referred to herein as "German Guidelines").

Ireland Competition Authority, *Notice in Respect of Guidelines for Merger Analysis*, Decision No. N/02/004, http://tca.ie/decisions/notices/n_02_004.pdf (Dec. 16, 2002) (referred to herein as "Irish Guidelines").

Japan Fair Trade Commission, *Guidelines for Interpretation on the Stipulation that "The Effect May Be Substantially to Restrain Competition in a Particular Field of Trade" Concerning M&As*, http://www.jftc.go.jp/e-page/guideli/maGL.pdf (Dec. 21, 1998) (referred to herein as "Japanese Guidelines").

New Zealand Commerce Commission, *Practice Note: 4, The Commission's Approach to Adjudicating on Business Acquisitions Under the Changed Threshold in Section 47 – A Test of Substantially Lessening Competition*, http://www.comcom.govt.nz/publications/getfile.cfm?doc_ID=303&filename=pnote428may01.pdf (referred to herein as "New Zealand Guidelines").

Romanian Competition Council, *Guidelines on Relevant Market Definition With a View to Determining the Significant Market Share*, http://www.globalcompetitionforum.org/regions/europe/Romania/Eguide%7E1.pdf (Mar. 21, 1997) (referred to herein as "Romanian Guidelines").

United Kingdom Office of Fair Trading, *Mergers: substantive assessment, A consultation paper*, http://www.oft.gov.uk/NR/rdonlyres/eecpmdiytaqv7d6xvi3qnz6kkk5rcyb7qodmcrgjhi3ylmsqy6brimbfstmvz5bhdupuqtg4ufprnnkskw2senkqxgf/oft506.pdf (Oct. 2002) (referred to herein as "UK OFT Guidelines").

United Kingdom Competition Commission, *Merger References: Competition Commission Guidelines*, http://www.competition-commission.org.uk/rep_pub/rules_and_guide/pdf/15073compcommguidance2final.pdf (June 2003) (referred to herein as "UK Competition Commission Guidelines").

United States Department of Justice and Federal Trade Commission, *Horizontal Merger Guidelines*, http://www.usdoj.gov/atr/public/guidelines/hmg.htm (revised Apr. 8, 1997) (referred to herein as U.S. Guidelines").

2. The merger guidelines of most jurisdictions recognize expressly that a transaction may alter the competitive dynamic of an industry in such a way as to alter the incentives of the competitors in a market, tipping a previously competitive market towards coordination and creating an adverse impact on competition. Most jurisdictions, however, do not fully examine the underlying economic interplay between firms that leads to a danger of coordinated interaction. Guidelines that explain the economic foundation underlying a merger's potential for illegal coordinated interaction provide useful information, as evident in the German Guidelines:

> Competition within an oligopoly is a "strategic game" of action and reaction. Against this background modern oligopoly theory is strongly based on the industrial economy aspects of game theory . . . Game theory takes account of the fact that other market participants are also active at the same time and thus have an influence on the market process. The same theory therefore assumes that every participant in the market follows his optimum strategy, which is designed in response to the optimum strategy of the other market participants . . . The corresponding interaction may lead on the one hand to intensive competition with low consumer prices and to product and process innovations. On the other hand, it can also result in long-term price rigidity and a transfer of competition to advertising and product differentiation without any technical progress. Oligopolies are therefore not good or bad *per se*. One type is particularly

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[3] It is not the authors' intent to provide a compendium or catalogue of guidelines currently in use. Instead, this work is intended as an inclusive, but not exhaustive, discussion of the precepts and practices used by enforcement agencies in merger analysis applying a coordinated effects theory of anticompetitive harm. For purposes of discussion, examples and specific reference are drawn from the guidelines of various jurisdictions; however, it should not be inferred from a reference to a practice of one jurisdiction that a similar example could not be found in the guidelines of another, or that the use of specific examples implies an endorsement of one jurisdiction's approach over another.

It is important to note that the guidelines issued by the countries subject to this study may not fully describe the exercise of substantive jurisdiction by the countries. This study does not undertake an analysis of actual formal or informal enforcement efforts. Therefore, limitations noted herein should be viewed solely as limitations of the horizontal merger guidelines of a country.

significant for competition policy and the application of competition law: non-competitive or only partly competitive oligopolies.[4]

3. As the German Guidelines make clear, an oligopolistic market structure is typically a necessary condition for the creation of coordinated interaction, but is insufficient grounds, on its own, for determining that coordinated interaction will exist.

II. SUBSTANTIVE STANDARD OF REVIEW: SLC VS. DOMINANCE

4. The evolution of competition policy has varied among jurisdictions. Two basic models have evolved. Some countries describe their efforts under a standard that seeks to prevent the "substantial lessening of competition" (SLC). Other jurisdictions have approached the issue from the standpoint of preventing the creation or enhancement of dominance.

5. Numerous jurisdictions have imposed a substantive standard of merger analysis that depends upon the creation or enhancement of a dominant position. Most notably, the European Community Merger Regulation (ECMR) had, until recently, relied on a dominance standard as a substantive test for evaluating proposed undertakings and determining whether such undertakings should be challenged, including in those instances where the underlying competitive concern stems from a theory of coordinated interaction theory of harm. From May 1, 2004, the substantive standard in the EC will change to that of "significantly impediment to effective competition", bringing it closer to the SLC test.[5] Where "dominance" is the controlling standard, as it is in Germany, it has been expressly applied to mergers

[4] German Guidelines, § II.A.1 (footnotes omitted).

[5] Council Regulation (EC) No 139/2004 of January 20, 2004 on the control of concentrations between undertakings O.J. L24/1. The Regulation has already entered into force and will apply from May 1, 2004.

through the concept of "collective dominance."[6] Collective dominance is based on the principle that tacit collusion or co-ordination in oligopolistic markets can lead to the joint exercise of dominance. Jurisdictions utilizing a dominance standard have developed their enforcement authority, in part, through jurisprudential review in this area of merger enforcement. In the EC, for example, there is clear legal authority for challenging such concentrations. For instance, in *Nestlé/Perrier*[7] the theory of collective dominance was explicitly applied by the EC and confirmed by the *Kali und Salz*[8] decision in 1993. The first outright prohibition on the basis of collective dominance occurred in *Gencor/Lonrho*[9] in 1995, followed by *Airtours/First Choice*[10] in 1999. This jurisprudence will continue to apply following the introduction of the new substantive test in the EC on May 1, 2004.

6. Other jurisdictions, such as the United States, Canada, and Australia rely on a "substantial lessening of competition" or "SLC" standard, which utilizes an analytical framework based in procedures for economic analysis of available market data and other relevant evidence in determining the likelihood that any transaction that is likely to result in an unacceptably high risk of an anticompetitive effect is

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[6] Similarly, Romania relies on a dominance test of anticompetitive effects.

[7] *Nestlé/Perrier* (Case No. IV/M.190) [1992] O.J. L356/1.

[8] *Kali und Salz/MdK/Treuhand* (Case No. IV/M.308) [1994] O.J. L186/38.

[9] *Gencor/Lonrho* (Case No. IV/M.619) [1997] O.J.L11/30.

[10] *Airtours/First Choice* (Case No. IV/M.1524) [2000] O.J. L93/1. The Commission's clearance decision was later annulled by the European Court of First Instance on June 6, 2002 (Case T-342/99). The Court held that the Commission had failed to demonstrate the existence of coordinated effects and did not prove that the merger would have adverse effects on competition.

unlawful. Under a SLC procedure-based approach, coordinated effects interaction is more directly recognized as potentially harmful to competition.

7. Substantive differences in the "dominant" and "SLC" standards of review have potential relevance in the analysis of individual cases under various merger regimes, if not in ultimate enforcement authority. For instance, lesser-developed jurisdictions implementing a "dominance" standard may have to develop the scope of authority to prohibit transactions resulting in anticompetitive coordinated interaction (as the more-developed jurisdictions have already done) through judicial review. This may be particularly relevant if the underlying legal authority for such action becomes an issue on appeal.

8. Notwithstanding a potential relevance in specific cases, the divergent standards of review seem not to have a measurable effect on the general exercise of enforcement jurisdiction authority on the basis of coordinated interaction for the jurisdictions whose guidelines were reviewed. More simply stated, every jurisdiction's guidelines recognize, to some extent, that the risk of competitive harm due to coordinated interaction can form the basis for a challenge (or refusal to approve) a transaction. Even so, recent decisions, for example in the EC, suggest that there is still some level of uncertainty with respect to the standard of proof that must be met in such cases, with some suggesting an implication of a movement toward a higher evidentiary threshold and stricter burden of proof.

III. RELATIONSHIP BETWEEN MARKET CONCENTRATION MEASURES AND COORDINATED EFFECTS

9. It is a well-recognized principle that a reduction in the number of firms in a market increases the potential for coordinated conduct, including both overt and tacit collusion. Many countries apply a presumption of illegality when a certain level of market concentration is reached. Conversely, some countries establish a “safe harbour” level of concentration, below which a merger is deemed unlikely to raise serious questions of competitive effect. In this regard, the issue of relevant market definition is central to the evaluation of coordinated interaction. Because a jurisdiction’s initial approach to coordinated effects begins with an evaluation of market concentration, the scope of the defined relevant product market is crucial.

10. Three concentration measures typically are utilized as a screening mechanism for analyzing the probability of coordinated interaction: (1) a market share test for the combined entity; (2) an industry concentration ratio (“CR”); and (3) the Herfindahl-Hirschmann Index (“HHI”). It should be noted that the first of these tests, which reviews only the shares of the merging firms and not the shares of other firms in the industry, is unlikely to identify transactions giving rise to concern over coordinated interaction. For example, in a four firm market, a merger between the third- and fourth-largest competitors may only result in a combined market share of 20% (which in most jurisdictions would not be deemed likely to result in single-firm dominance), but might significantly increase the likelihood of tacit collusion.

11. Jurisdictions using an HHI approach include the United States, Ireland and the EC. The U.S. Guidelines deem a merger resulting in an HHI greater than 1800, with an

increase greater than 100, as presumptively resulting in anticompetitive effects.[11] The Irish Guidelines, using the same HHI levels as a trigger, do not establish a presumption of anticompetitive effect, but instead indicate that such transactions are "more usually . . . those that raise competitive concerns."[12] The EC Guidelines state that the EC is unlikely to investigate a concentration that leads to a post-merger HHI of less than 1000.[13]

12. Other jurisdictions rely on an industry concentration ratio or "CR" as a preliminary indicator of the likelihood of coordinated effects. Brazil deems a transaction as *likely* to raise concern if the four leading firms (i.e., CR4) accounts for at least 75% of the total market share and the merged firms' share would be greater than 10%.[14] In Germany, an oligopoly is *presumed* to be dominant if the CR3 is greater than 50% and the CR5 is greater than two thirds (66.7%).

13. Japan does not impose a presumption of illegality, but notes that if the number of competitors decreases and the market becomes an oligopolistic market--for example if the CR3 exceeds 70%--the tendency toward cooperative conduct between

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[11] U.S. Guidelines, § 1.51(c). The U.S. guidelines emphasize the importance of several additional factors in determining a transaction's likely competitive effect and caution against relying solely on concentration levels, such as those provided by the HHI.

[12] Irish Guidelines, ¶ 3.10.

[13] EC Guidelines, ¶ 19. The EC Guidelines also state that a merger leading to a post-merger HHI of 2000 or more and a delta below 150 is likely to raise competition concerns except, for instance, when one or more of the following factors are present: "(a) a merger involves a potential entrant or a recent entrant with a small market share; (b) one or more merging parties are important innovators in ways not reflected in market shares; (c) there are significant cross-shareholdings among the market participants; (d) one of the merging firms is a maverick firm with a high likelihood of disrupting coordinated conduct; (e) indications of past or ongoing coordination, or facilitating practices, are present; and (f) one of the merging parties has a pre-merger market share of 50 % of more." *See* EC Guidelines, ¶ 20. In commentary, the EC has indicated that this higher threshold applies only to non-collusive oliogopolies.

[14] Brazilian Guidelines, ¶ 48.

competitors will be considered.[15] Similarly, Australia will be more likely to investigate a merger where the CR4 is greater than 75% and the share of the merged firm is greater than 15%.[16]

14. New Zealand creates a safe harbour where the CR3 does not exceed 70%, or, if above 70%, the share of the combined entity is less than 20%.[17] Similarly, Canada imposes a safe harbour where the CR4 is less than 65% and the share of the merged firm is less than 10%.[18] In all of these cases, the merged firms' share of the relevant market also must be of sufficient dimension (typically 10-15%) in order for a concern to be raised.

15. The only country employing a pure market share test is Romania, which concludes that an affected market may be created where the combined share of the parties, post-concentration, exceeds 15%.[19] Romania's law with respect to coordinated interaction, however, is not as well-developed as that of many other jurisdictions.

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[15] Japanese Guidelines, § 3(B)(2)(a).

[16] Australian Guidelines, ¶ 5.95.

[17] The New Zealand Guidelines compare their safe harbour to the CR levels used by Australia and intentionally choose a higher level in recognition of New Zealand's smaller economy and generally more concentrated markets. *See* New Zealand Guidelines, § 4.4.

[18] Canadian Guidelines, § 4.2.1.

[19] Romanian Guidelines, § 3.

16. The UK Office of Fair Trading uses a hybrid approach, considering all three measures in its assessment of a proposed concentration, but does not impose any presumption of illegality or grant any safe harbour based on these levels.[20]

IV. ELEMENTS OF COORDINATED INTERACTION

17. Successful coordinated interaction is dependent upon a number of complex market variables that, in any given case, may point in opposite directions. Thus, jurisdictions generally have identified the market factors that weigh on the analysis of coordinated interaction and describe the circumstances in which these factors are likely to favor coordination. Ultimately, the balancing of these factors falls within the prosecutorial discretion of the individual agency.

18. There is general agreement that the presence of three conditions are most relevant to the analysis of coordinated effects: 1) whether the coordinating parties are able to establish terms of coordination; 2) whether the participating parties are able to monitor each other's adherence to the terms of coordination and to detect deviations from the established terms; and 3) whether effective deterrence mechanisms exist to discourage and effectively discipline deviation from the terms of agreement by coordinating parties. Each of these conditions, and the market conditions that indicate their presence, is discussed below.

A. Terms Conducive to Coordination

[20] UK OFT Guidelines, ¶ 4.3 – 4.4.

19. The guidelines uniformly recognize the role that stable markets play in coordinated interaction among rivals. This concept is described in the EC Guidelines: "the less complex and the more stable the economic environment, the easier it is for the firms to reach a common understanding on the terms of coordination."[21] The risks of coordination are highest when the conditions for reaching terms of coordination are favorable and when participants have little incentive for departing from the terms that are established.[22]

20. Reaching terms of coordination requires that a firm have sufficient knowledge and certainty about the likely reactions of competitors. At the same time, competitors need not perfect the terms of coordination in order to harm competition. The ability to establish even the basic parameters of collusion may be a sufficient foundation for coordinated interaction, even in a complex market. This is explained in the U.S. Guidelines as follows:

> Firms coordinating their interactions need not reach complex terms concerning the allocation of the market output across firms or the level of the market prices but may, instead, follow simple terms such as a common price, fixed price differentials, stable market shares, or customer or territorial restrictions. Terms of coordination need not perfectly achieve the monopoly outcome in order to be harmful to consumers. Instead, the terms of coordination may be imperfect and incomplete--inasmuch as they omit some market participants, omit some dimensions of competition, omit some customers, yield elevated prices short of monopoly levels, or lapse into episodic price wars--and still result in significant competitive harm. At some point, however, imperfections cause the profitability of abiding by the terms of

[21] EC Guidelines, ¶ 45.

[22] Brazilian Guidelines, ¶ 79.

coordination to decrease and, depending on their extent, may make coordinated interaction unlikely in the first instance.[23]

21. This explains the ability of coordinating firms to find ways of overcoming problems stemming from complex economic environments.[24] At the same time, it should be recognized that as the complexity of the marketplace dynamic increases, the ability to establish functional terms of coordination decreases, especially when such terms must be established by tacit agreement.

22. Jurisdictions generally recognize that certain conditions will increase the likelihood of coordinated interaction. A number of these factors are accepted universally as increasing the likelihood of coordination.

1. Highly Concentrated Market

23. Coordination is simplified when the number of market participants is small and the likely responses of competitors are easier to forecast. As stated in the Canadian Guidelines, "other things being equal, the likelihood that a number of firms may be able to bring about a price increase through interdependent behavior increases as the level of concentration in a market rises and as the number of firms declines."[25]

2. Homogeneity of Products

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[23] U.S. Guidelines, § 2.11. *See also* EC Guidelines, ¶ 47. ("Co-ordinating firms may, however, find other ways to overcome problems stemming from complex economic environments short of market division. They may, for instance, establish simple pricing rules that reduce the complexity of co-ordinating on a large number of prices.")

[24] *See* EC Guidelines, ¶ 47.

[25] Canadian Guidelines, § 4.2.1.

24. Coordination is simplified when the level of product differentiation is minimal. Markets characterized by relatively undifferentiated products typically involve fewer terms of sale, making it easier for competitors to predict the likely responses of their rivals.

3. Homogeneity of Firms

25. Firms with similar capacity, similar cost structure, common aspects of vertical integration, similar market share, or some combination of these factors are more likely to coordinate. Symmetry among firms increases the probability that the firms will have compatible incentives in response to a particular set of competitive circumstances.[26]

4. Stable Demand

26. Stability of market demand is likely to result in predictable patterns of behavior by market participants, increasing the ability to coordinate.[27] Moreover, stable market demand may promote the entrenchment of sales positions, leading to tacit allocation of customers among sellers.

5. Additional Indicia of Likely Coordination

27. A number of jurisdictions, most notably Australia, Brazil, the EC, New Zealand and the U.S., highlight additional factors as increasing the probability of coordinated

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[26] *See*, *e.g.*, EC Guidelines, ¶ 48.

[27] Australian Guidelines, ¶ 5.168.

interaction. These factors may also speak to other aspects of coordinated interaction, such as the ability to detect or punish deviation.

a) Absence of Potential Entrants or Fringe Competitors

28. The absence of potential entrants or fringe competitors increases the likelihood that coordinated conduct will not be challenged, especially if such firms are present but unable to expand capacity readily.[28] This concept often is captured by the guidelines in an analysis of entry conditions or potential competition generally.

b) History of Coordination

29. A history of past price-fixing or other forms of express collusion in an industry are often indicative of whether or not conditions are favorable to coordination.[29] It should be noted, however, that express collusion is possible in markets that are not well-adapted to tacit coordination. This is particularly true in markets where the terms of sale are complex.

c) Presence of Standardized Pricing or Product Variables

30. Coordinated interaction is facilitated by the establishment by firms of standardized pricing and product variables, such as pricing rules that would reduce the complexity of coordinating on a large number of prices. Examples of these rules, as noted in the EC Guidelines, are establishing a small number of pricing points, thus reducing the co-ordination problem, and having a fixed relationship between certain

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[28] *Id. See also* New Zealand Guidelines, § 6.2 (footnotes omitted).

[29] *See* New Zealand Guidelines, § 6.2 (footnotes omitted).

base prices and a number of other prices, such that prices basically move in parallel.[30]

d) Transparency of Prices or Other Terms of Sale

31. Transparency of prices and structural links make it easier for agreements to be monitored and incentives to be aligned.[31] Indeed, transparent pricing or terms of sale not only indicate a higher likelihood that coordination will occur; it also enables coordinating firms to monitor their rivals' adherence to the terms of coordination.[32]

e) History of Government Price Controls

32. At least one jurisdiction has noted that there is an increased likelihood of coordinated interaction when companies were involved in or were subject to price controls due to its own government's policies.[33]

f) Presence of Industry Trade Associations

33. Industry trade associations may increase the probability of coordinated interaction as they may act as fora through which information on prices and outputs between market participants may flow. These associations may also work as facilitators of

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[30] EC Guidelines, ¶ 47. *See also* U.S. Guidelines, § 2.11.

[31] *See* Australian Guidelines, ¶ 5.168; and EC Guidelines, ¶ 47 – 48.

[32] U.S. Guidelines, § 2.1.

[33] *See* Brazilian Guidelines, ¶ 78.

express collusive agreements.[34] It should be noted that such associations can often serve pro-competitive purposes.

34. Most guidelines are clear that the formation of coordinated interaction does not require overt or express agreement. Thus, a merger or other concentration may result in a violation of the competition laws of the jurisdiction without a *per se* horizontal agreement that would otherwise violate a jurisdiction's antitrust laws.[35]

B. Detection of Deviation

35. Effective tacit collusion requires that the participants be able to effectively monitor each other's adherence to the terms of coordination and detect any deviation. Firms engaged in tacit collusion are continually choosing between maintaining the terms of collusion by keeping prices high and limiting their opportunities with certain buyers, or deviating from the terms of collusion by lowering prices or increasing capacity in order to increase their sales. Firms will find it more profitable to engage in coordination where the likelihood of adherence by their rivals is high. Thus, market conditions that make it easier for competitors to monitor each other's behavior will both facilitate the formation of coordinated interaction and support its execution.

36. By contrast, where detection of a competitor's deviation from the terms of collusion is likely to be slow or uncertain, the incentives to coordinate are diminished because

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[34] *See* Australian Guidelines, ¶ 5.168; and New Zealand Guidelines, § 6.2 (footnotes omitted).

[35] *See*, *e.g.*, Australian Guidelines, ¶ 5.167. ("While the exercise of unilateral market power does not require accommodating action by remaining firms in a market, the exercise of coordinated market power does. This does not necessarily involve collusion of the kind covered by s. 45 but may simply involve signalling or conscious parallelism.")

each participant has less certainty about its competitors' adherence to the scheme and the expected returns from adherence to the scheme are therefore reduced. In other words, the odds that a firm will "cheat" are lower if it would be caught doing so.

37. There are a number of market factors that address the ability to monitor and detect deviations from a collusive scheme.

1. Availability of Market Information

38. The ability to monitor market prices or output, for example in markets that utilize a public exchange, where offers and demands are matched, or in which pricing or output information is readily available, provides an ability to monitor adherence to a collusive scheme.[36] As the UK Competition Commission has noted, however, "even where prices are not transparent, as is often the case in intermediate markets, any deviation from the prevailing behavior by a competitor may nonetheless be readily apparent, because the essence of interdependence is that price cuts by one firm will have a significant impact on others' volumes."[37]

39. At the same time, where market transparency is inhibited, the ability to detect deviations from the collusive scheme may be limited. This may occur when prices between the buyer and seller are privately negotiated or where observable prices do not reflect meaningful discounts, allowances or other incentives.

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[36] *See* EC Guidelines, ¶ 50.

[37] UK Competition Commission Guidelines, ¶ 3.37.

2. Presence of Demand Fluctuations

40. Unpredictable changes in demand or price can undermine the ability to monitor and detect deviations from a coordinated scheme. As the EC Guidelines explain, "[c]oordinating firms should be able to interpret with some certainty whether unexpected behavior is the result of deviation from the terms of coordination. For instance, in unstable environments it may be difficult for a firm to know whether its lost sales are due to an overall low level of demand or due to a competitor offering particularly low prices. Similarly, when overall demand or cost conditions fluctuate, it may be difficult to interpret whether a competitor is lowering its price because it expects the coordinated prices to fall or because it is deviating."[38] In essence, inelastic demand increases a firm's expected return on its decision to coordinate rather than compete.[39] Most jurisdictions do not acknowledge this aspect of detection, which is undoubtedly important to the analysis of coordinated interaction.

3. Presence of Downstream Affiliate

41. Vertical relationships may enable price signaling or price monitoring upstream or downstream of the level of competition affected by the merger, thereby increasing the likelihood of coordination. For example, where firms X and Y compete in the production of product P, the acquisition by X of Y's distribution facilities (but not Y's production facilities) may increase the ability of X to monitor Y's output and pricing of P, even if the merger did not appreciably increase the level of

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[38] EC Guidelines, ¶ 50.

[39] Australian Guidelines, ¶ 5.168.

concentration in the distribution of P. Although this situation would not always, and perhaps would rarely, give rise to an anticompetitive effect – *i.e.*, facilitating coordinated interaction that would not otherwise occur – it should be considered by enforcement authorities in merger analysis.[40]

C. Effective Deterrent or Punishment

42. Firms engaged in tacit collusion may have the incentive to deviate from the terms of coordination, even if such deviation would be quickly detected, if there is no effective mechanism by which they would be punished by their rivals. Thus, it is the threat of future retaliation that keeps the coordination intact by increasing the cost of deviation and, thereby, the net benefit of coordination.

1. Credibility of Threatened Retaliation

43. In order for deterrence to be effective, the threat of retaliation must be credible and enacted in a timely manner. Retaliation that is quickly implemented has the effect of reinforcing competitors' resolve to punish deviation and, in some cases, may limit the gain that would otherwise be realized from the deviation.[41]

44. Punishment that could only occur after the passage of significant time or which is not likely to be imposed decreases the level of deterrence and increases the likelihood that parties will engage in competition rather than coordination.

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[40] *See* Australian Guidelines, ¶ 5.159; Brazilian Guidelines, ¶ 80; EC Guidelines, ¶ 51; Irish Guidelines, ¶ 6.6; New Zealand Guidelines, § 9.2; and UK OFT Guidelines, § 5.4.

[41] *See* EC Guidelines, ¶ 52.

45. Moreover, competition agencies should recognize that it may be difficult to accurately discern between a competitive market and a market characterized by a frequent pattern of deviation and punishment. Guidelines should recognize that such a pattern may suggest either that the benefits of collusion (versus competition) are small or that deterrence mechanisms are weak.

2. Nature and Distribution of Excess Capacity

46. The ability to retaliate may require that non-deviating parties have sufficient excess capacity, either individually or collectively, to discipline the deviating party. Guidelines recognize that excess capacity is a factor to be considered in analyzing the likelihood of coordination and retaliation.[42]

V. CONSIDERATION OF ADDITIONAL FACTORS

A. Acquisition of a "Maverick" firm

47. Most guidelines recognize that the presence of a "maverick" firm can effectively prevent coordinated interaction, even where the conditions for establishing coordinated interaction are present.[43] A maverick firm is one that has a greater economic incentive to deviate than do most of its rivals and constitutes an unusually disruptive force in the market place.[44]

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[42] EC Guidelines, ¶ 54; New Zealand Guidelines, § 6.2; and UK Competition Commission Guidelines, ¶ 3.41.

[43] Irish Guidelines, § 4.24; UK OFT Guidelines, § 4.17; and U.S. Guidelines, § 2.12.

[44] U.S. Guidelines, § 2.12

48. In some cases, an acquisition of a maverick firm may enhance the probability that coordination will occur post-merger.[45] A maverick firm may be able to disrupt coordination among other competitors even if the maverick has a relatively small presence in the market. Thus, the acquisition of a true maverick may substantially increase the likelihood of coordination even where the increase in concentration in the market is modest.[46]

49. The effectiveness of the maverick firm is likely to be high where the maverick has the ability to absorb a significant share of business. Thus, a merger may be less likely to result in coordination where the industry maverick is not a party to the transaction and where the economic incentives of the maverick would be undisturbed by the transaction. The guidelines generally do not explicitly recognize this consequence of a maverick's presence in a market.

B. Coordination in Bidding Markets

50. Where the market for a good is characterized by customer tenders and supplies bids, coordination may occur through a tacit understanding about which party will be permitted to win each tender. The removal of a competitor, through a concentration, that otherwise would be expected to prevent the coordination of bids may cause competitive harm.[47]

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[45] Irish Guidelines, ¶ 4.24.

[46] See, e.g., Jonathan B. Baker, Mavericks, Mergers and Exclusion: Proving Coordinated Competitive Effects Under the Antitrust Laws, 77 N.Y.U. L. REV. 135, 177-179 (2002).

[47] EC Guidelines, ¶ 40.

51. The mechanism by which coordination is likely to occur in bid markets is not well established in the guidelines. Generally, agencies should be concerned that the remaining bidders will become entrenched in existing customer relationships, tacitly agreeing not to "raid" each other's customers for fear of being similarly raided by their rivals. This risk of entrenchment likely would be higher where customers' switching costs are high.

52. The increased likelihood that coordination of bids will occur, and the resulting risk of tacit collusion, should not be confused with the unilateral effects concern that may also arise in bid markets. In the instance of unilateral effects, the concern arises when the two best-situated bidders are merging regardless of the total number of bidders in the market. In the coordinated effects case, the concern arises because of the elimination of one of a few bidders that is likely to facilitate a scheme of coordination among remaining bidders.

C. Ability to Sustain Collusion

53. The UK OFT Guidelines state that a condition of successful tacit coordination is the ability to sustain the coordinated behavior in the face of other competitive constraints in the market.[48] This is a useful recognition that issues such as entry, reaction by fringe competitors, efficiencies, import restrictions and failing firm issues should be fully considered, even if the conditions of coordinated interaction are met. It is critical that the possibility of coordinated interaction be considered in

[48] UK OFT Guidelines, ¶ 4.12.

the context of the dynamics of the industry and take account of future conditions that may undermine or facilitate the possibility of collusion.

D. Factors with Ambiguous Effect

54. Many of the guidelines describe the factors to be considered in evaluating the likelihood of coordination, the rationale behind the analysis of the factors, or both. In a few instances, however, guidelines identify factors that are of ambiguous significance in the analysis of coordinated interaction. We have identified some of these factors below.

55. The German Guidelines state that of all the factors that may enter into an analysis of coordinated interaction, special attention should be paid to market share, barriers to entry/potential competition, and assessment of financial resources.[49] This latter point is suspect in the analysis of coordinated effects. Agencies have clearly disagreed on the propriety of considering a firm's financial resources in merger analysis. (*Compare, e.g.*, the U.S. and EC results in *GE/Honeywell*.[50]) To the extent that the analysis is at all relevant, however, it appears to relate to the unilateral ability of a firm to utilize its financial resources to secure or advance a dominant position. In the context of coordinated interaction, experience has demonstrated that a firm's financial condition is not a meaningful indicator of its incentive to collude. Cost structure, excess capacity and other economic factors

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[49] German Guidelines, § II.B.3.

[50] See Press Release, U.S. Department of Justice, Antitrust Division, "Justice Department Requires Divestitures in Merger Between General Electric and Honeywell" (May 2, 2001), http://www.usdoj.gov/atr/public/press_releases/2001/8140.htm; and *General Electric/Honeywell*, Case No. COMP/M.2220, Commission Decision C(2001)1746 (July 3, 2001), *available at*: http://www.europa.eu.int/comm/competition/mergers/cases/decisions/m2220_en.pdf.

are undoubtedly important, but "superior resources" would not appear relevant.[51] Indeed, coordination may often occur between firms with a strong financial position and those with a weak position.

56. The EC Guidelines note that "[r]etaliation need not necessarily take place in the same market as the deviation."[52] This principle, however, should more fully recognize the difficulty in discerning between retaliation and competition. For instance, retaliation in the same market as the alleged deviation can undoubtedly chill competition. However, to the extent that retaliation may occur by way of alleged price undercutting in order to "send a message" to the deviating firm, such action has at least a short-term competitive benefit. Thus, authorities should be cautious in deeming such action as retaliation unless it creates a direct response by the company that "cheated" on the tacit agreement. Moreover, the "message" (if indeed it is tacit) is less likely to be received as retaliatory as the parties move away from the market subject to collusion. Accordingly, an assumption that action in an unrelated market constitutes retaliation could chill competition by firms in other markets. In this regard, retaliation that is executed through vertical relationships or in closely related markets should perhaps be considered as evidence of tacit collusion only in light of an actual disciplining response by the "cheating" party or in light of evidence of intent by the retaliating party.

VI. CONCLUSION

[51] German Guidelines, § I.B.2.

[52] EC Guidelines, ¶ 55.

57. There is a large degree of consensus regarding the factors that are likely to lead to coordinated interaction as the result of a concentration in a market. Some jurisdictions, such as Canada, Germany, the EC and the U.S., have issued guidelines that provide valuable insight into the analytical framework for evaluating the possibility of coordinated interaction. Other jurisdictions have guidelines that are less developed, but are nonetheless consistent in their framework with the more expansive guidelines.

58. We believe there is tremendous value in the development of explicit, well considered guidelines describing both the theoretical basis and the analytical methodology for evaluating the potential for coordinated interaction. A detailed discussion in the guidelines of all countries will serve to reduce the uncertainty of merger approval, reducing the number of potentially anticompetitive transactions attempted and increasing the number of beneficial transactions that may be inhibited by uncertainty.

CHAPTER 5 - ASSESSMENT OF MARKET ENTRY AND EXPANSION (BARRIERS TO ENTRY)[1]

I. INTRODUCTION

1. As stated in Chapter 1, even a merger that materially increases market concentration may not be anticompetitive if new firms would enter the market (or expand production) and prevent incumbents from exercising market power. In theory, if entry is easy, the monopoly rents resulting from an anticompetitive post-merger reduction in output and increase in price will attract new firms to the market and force prices back down to competitive levels. If entry is not easy, however – if there are "barriers to entry" – then new entry may not dissipate the post-merger exercise of market power within a reasonable period of time. In such cases, legal intervention to prevent an otherwise anticompetitive merger may be necessary.
2. There is broad agreement among jurisdictions on this basic concept. Each of the "core" merger enforcement guidelines surveyed for this report require competition authorities to consider whether market entry or expansion would deter or counteract the anticompetitive effects of a merger. Most guidelines expressly require that, to be effective, entry must be (i) likely, (ii) timely and (iii) of sufficient nature, scale and scope to constrain anticompetitive effects.
3. Having stated the widely accepted theory, however, the more difficult question for policy-makers is how best to assess the actual likely effect of entry or expansion in respect to an actual merger. Complex judgments have to be made about whether sufficient entry likely would occur on a timely basis and act as an effective

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competitive constraint, given the requirements and costs of entry and the likely responses of incumbent firms.

4. Countries have adopted somewhat different analytical constructs by which to make these judgments, which they continue to evolve. For example, many jurisdictions (but not all) distinguish between entry in the short term and entry in the medium term. They treat the former as a form of supply-side substitution considered in defining the relevant market (the EU position) or identifying participants in the market (the U.S. position), and consider the latter in their competitive assessment of the merger. (See discussion in Chapter 2, Market Definition.) In addition, the U.S. and Brazilian guidelines, for example, employ a "minimum viable scale (MVS)" analysis to help determine the probability of competitively effective entry which others do not.

5. It is not clear that these differences in approach necessarily result in different outcomes. No one approach seems clearly more likely in practice than the others to answer correctly the common entry question all countries ask, although there are advantages and disadvantages to each. The ICN should monitor experience under the guidelines—many of which have only recently been adopted—to determine whether material differences arise in practice. In addition, individual jurisdictions should consider whether more concrete guidance can be given as to how they assess and weight various factors affecting the likelihood and competitive sufficiency of entry.

6. This chapter describes how various countries assess entry and expansion in examining the likely competitive effects of horizontal mergers, including a

discussion of the possible forms of new entry and the three key elements of: (i) likelihood, (ii) sufficiency, and (iii) timeliness.[2]

II. SOURCES OF NEW ENTRY

7. In general, a range of entry responses are possible, from so-called "hit and run" entry involving relatively low cost of entry and exit, to entry over the longer-run that involves significant costs of entry and exit. The difference may be described in terms of timing and/or investment. Some supply responses occur in the short run with little or no investment required and provide for the immediate possibility to participate in the market (this is short-term entry). Other supply responses, however, are likely to occur over a longer period and may require more significant investment (this is medium-term entry).

8. As noted above, many guidelines attempt to distinguish between the two concepts, although in practice the distinction has proved to be more blurred. Some jurisdictions (like the EU) refer to this distinction as supply-side substitution (short-term entry) versus potential entry (medium-term entry).[3] Others (like the United States and Brazil) refer to the distinction as "uncommitted" entry versus

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2 This chapter does not discuss the substantive analysis of mergers that involve the acquisition of a potential entrant or that may be anticompetitive because they create "barriers to entry" (e.g., "vertical" mergers involving the acquisition of control over a scarce input needed to enter an upstream or downstream market), except insofar as the merger itself makes entry that would constrain its potential anti-competitive effects less likely. It should also be noted that, in some jurisdictions, approval of a merger may be conditioned on an undertaking by the merged entity designed to facilitate post-merger entry that would constrain anticompetitive pricing. *See, e.g.,* Case No. 08012.005846/99, Brahma/Antarctica, Decision of the Brazilian CADE - Administrative Council for Economic Development (Mar. 30, 2000) (requiring merged entity to provide access to its distribution network in order to facilitate new entry). Discussion of such remedial provisions are beyond the scope of this chapter.

3 European Commission Notice on the definition of relevant market for the purposes of Community competition law, [1997] O.J. C 372/5, ¶¶ 23 - 24. See also discussions of the adaptation of existing facilities, at para. 16, *infra*. It is not surprising that considerations that are relevant to defining the relevant market may also be relevant in analyzing potential entry (imports are thus often an important factor in defining the relevant geographic market). On the other hand, it may sometimes be difficult to distinguish the assessment of the relevant market from the analysis of potential competition (*e.g.*, in the case of supply-side substitution).

"committed" entry.[4] Uncommitted entrants are treated as current market participants and assigned market shares where possible.

9. Applying the distinction can help to guide and shorten analysis. For example, when a merger occurs in a market in which entry requires little by way of sunk investment, and the number of prospective entrants are not limited, there may be no need to look for committed or medium-term entrants.[5] But it is not essential to distinguish the two concepts in order to arrive at the correct result, and many jurisdictions have chosen not to do so, perhaps because of the practical difficulties that may be entailed in distinguishing whether entry is committed or uncommitted (or short-term or medium-term).

10. In general terms, new entry (committed or uncommitted) can take several forms.[6] While most of the merger guidelines surveyed for this report provide extensive guidance on barriers to entry and expansion, they do not provide similar detail in regard to the form of entry. A few guidelines include a non-exhaustive list of entry alternatives,[7] but do not rank them in order of importance for the competitive

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4 See Brazil SEAE/SDE Joint Resolution No. 50, Guidelines for the Analysis of Horizontal Merger Concentration (Aug. 1, 2001) (hereinafter, "Brazil Guidelines"), ¶¶ 50, 51; U.S. Department of Justice and Federal Trade Commission, Horizontal Merger Guidelines (Apr. 8, 1997) (hereinafter, "U.S Guidelines"), ¶ 3.0.

5 See Jonathan B. Baker, Responding to Developments in Economics and the Courts: Entry in the Merger Guidelines (2002) at 19, available at http://www.usdoj.gov/atr/hmerger/11252.pdf (hereinafter, "Baker").

6 See list of sources of potential competition in XXIst Report on Competition Policy (1991) ("XXIst Report") at 363 - 365.

7 United Kingdom, Merger References: Competition Commission Guidelines, June 2003 (hereinafter, "U.K. Guidelines"), ¶ 3.46; New Zealand, Commerce Commission, Mergers and Acquisitions Guidelines (hereinafter, "New Zealand Guidelines"), ¶ 6.1. The European Commission ("EC") takes the view that "the most realistic and strong potential competition" is the expansion of capacity by established competitors and potential imports from another geographic market. See XXIst Report at 365. However, the EC has not ranked the various sources of entry in its recent Draft European Commission Notice on the Appraisal of Horizontal Mergers Under the Council Regulation on The Control of Concentrations Between Undertakings, COM (2002), December 11, 2002, Adopted by the European Commission on December 16, 2003 [To Be Effective May 1, 2004] (hereinafter, "Draft EC guidelines").

assessment.[8] In any case, entry must result in actual or potential competition that limits the market power acquired by the undertaking resulting from a concentration.

11. ***Imports from other regions***. Imports are often considered in delimiting the relevant geographical market, *i.e.*, whether a market is national in scope. In cases where the level of imports does not justify the delimitation of a wider geographic market than the national one, the level of imports may also be taken into account to evaluate the possibility of potential competition.[9] Australia, in particular, often considers imports to be a decisive factor in the approval of a concentration.[10] In some instances, imports may be the only additional potential competitive constraint—for example, where additional capacity can only be expected from the "de-bottlenecking" of existing producers' facilities and new companies are not expected to enter the market.[11]

12. Competition authorities consider a number of factors in determining whether customers would switch to imported products in response to an anticompetitive price increase, including factors such as tariff and non-tariff barriers to international

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8 Cf. (Canada, Merger Enforcement Guidelines (Mar. 1991) ("Canada Guidelines") ¶ 4.6.1 (In assessing the likelihood of future entry, Canada generally begins by assessing firms that appear to have an entry advantage, i.e., fringe firms already in the market and firms that sell the relevant product in a geographically adjacent market, control technology or assets that can be used to produce the relevant product, already operate in vertically-related markets, sell through similar distribution networks, or use similar marketing and promotional methods; such firms "are typically the most important sources of potential competition").

9 Case No COMP/M. 2662, *Danish Crown / Steff-Houlberg*, Decision of the European Commission (Feb. 14, 2002), ¶¶ 30-37.

10 See Australian Competition and Consumer Commission, Merger Guidelines (June 1999) (hereinafter, "Australian Guidelines") ¶ 5.111 ("The Commission has not objected to any merger where comparable and competitive imports have had a sustained market share of 10 percent or more for at least three years, and–as an indicative guideline–it is unlikely to do so. However, it should be emphasized that it is not the historical share of imports that is significant, but their potential to constrain the price and output decisions of the merged firm.") See also, Japan, Guidelines for Interpretation on the Stipulation Concerning M&As (1998) (hereinafter, "Japan Guidelines"), 3.B.(2)(b); Brazil Guidelines at ¶ 44.

11 Case No. COMP/M.2389, *Shell - DEA*, Decision of the European Commission (Dec. 20, 2001), ¶ 72; Case No. IV/M.1313, *Danish Crown /Vestjyske Slagterier*, Decision of the European Commission (Mar. 9, 1999), ¶¶ 150 - 151.

trade, consumer preferences,[12] security issues, transport costs, the effect of exchange rates, the apparent current price impact of imports, the extent to which imports are independent of domestic suppliers for distribution, and whether existing supply routes could accommodate significant expansion without significant sunk cost investment.[13] Australia generally will not challenge a merger where imports have accounted for at least ten percent or more market sales for at least three years.[14] As a rule of thumb, Brazil will consider imports to be a sufficient market force to prevent anticompetitive behavior where they would increase within one year to at least 30 percent of the total market demand.[15]

13. ***Expansion of capacity***. The expansion of capacity or the use of excess capacity by firms already in the relevant market can in some cases also constrain anticompetitive price increases by the merged entity.[16] Expansion of capacity can occur through capacity "creep," de-bottlenecking, roundout or "brownfield" expansion at existing sites, or new so-called "Greenfield" projects. In each case, competition authorities undertake a detailed assessment of the ability of individual firms to expand their capacity.[17] For example, the addition of new capacity may

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12 See, e.g., Case No. IV/M.113, *Courtaulds/SNIA*, Decision of the European Commission (Dec. 19, 1991), ¶ 24; Case No. COMP/M. 2662, *Danish Crown / Steff-Houlberg*, Decision of the European Commission (Feb. 14, 2002), ¶ 30-37.

13 See, e.g., Australia Guidelines ¶ 5.112; Brazil Guidelines ¶ 44; Germany, Principles of Interpretation (Oct. 2000) (hereinafter, "Germany Guidelines") ¶¶ 5.2, 5.4. See also, e.g., Case No. COMP/M.1813, *Industrie Kapital(Nordkem) Dino*, Decision of the European Commission (Jul. 12, 2000), ¶ 106.

14 Australia Guidelines ¶ 5.111.

15 Brazil Guidelines ¶ 43.

16 See, e.g., Canada Guidelines ¶ 4.6.1; New Zealand Guidelines ¶ 6.1; Finland Merger Guidelines (Sept. 15, 1998) (hereinafter, "Finland Guidelines"), 43-45. See also Case No. IV/M.042, *Alcatel / Telettra*, Decision of the European Commission (Apr. 12, 1991), ¶¶ 38 – 40; Case No. IV/M.315, *Mannesmann/Vallourec/Ilva*, Decision of the European Commission (Jan. 31, 1994) [1994] OJ L102/15, ¶¶ 116 – 124. Conversely, where competitors lack the capacity to deal with a short-term increase in demand, expansion of capacity may not constitute a source of new entry. See *Tetra Pak/Alfa-Laval*, ¶ 3.3.

17 Compare New Zealand Guidelines at ¶ 6.1.

not be taken into account where it is intended primarily to cover the internal needs of the major integrated producers.[18]

14. ***Entry of new competitors into the relevant product market***. Firms that are not already operating in the relevant market or in markets related to the relevant market may enter *de novo*.[19] Such entry can occur through taking over existing capacity and using it in new or more productive ways, or through building new capacity.[20] New entrants can adopt aggressive pricing strategies that the incumbents would have to match.[21]

15. ***Entry of In-House Capacity Into the Merchant Market***. A further potential source of new entry comes from vertically integrated firms that might choose to expand into the merchant market, using existing excess capacity or adding to its in-house capacity.[22] In extreme cases, a company might spin off its in-house production facilities, turning it into a new "independent" merchant supplier.

16. ***Adaptation of existing facilities***. There is some discussion about the extent to which the adaptation of existing facilities may form part of the entry analysis.[23]

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18 See, e.g., Case No. COMP/M.1693, *Alcoa/Reynolds*, Decision of the European Commission (May 3, 2002), ¶¶ 30, 35.

19 See, e.g., U.K. Guidelines ¶ 3.46. See also, Case No. COMP/M.1915, *The Post Office/TPG/SPPL*, Decision of the European Commission (Mar. 13, 2001), ¶¶ 75 – 83.

20 U.K. Guidelines ¶ 3.46.

21 See Case No. IV/M.727, *BP/Mobil*, Decision of the European Commission (Aug. 7, 1996), ¶ 40.

22 See, e.g., U.K. Guidelines ¶ 3.46. Examples of backwards integration concern in particular the automotive industry: Case No. IV/M.134, *Mannesmann / Boge*, Decision of the European Commission (Sept. 21, 1991), ¶ 30; Case No. IV/M.149, *Lucas/Eaton*, Decision of the European Commission (Dec. 9, 1991), ¶ 37; Case No. IV/M. 139, *Viag/EB-Brühl*, Decision of the European Commission (Nov. 19, 1991), ¶ 19. See also Case No. IV/M.1597, *Castrol/Carless*, Decision of the European Commission (Dec. 14, 1999), ¶ 28; Case No. IV/M.1599, *DuPont/Teijin*, Decision of the European Commission (Nov. 24, 1999), ¶ 22. It is also possible that a customer having some in-house production of a product or service will respond to an anticompetitive price increase by turning to self-supply or increased self-supply.

23 New Zealand Guidelines ¶ 6.1.

The European Commission, for example, considers the reallocation of production facilities as one possible form of entry,[24] while in many instances the adaptation of facilities may be labeled as supply-side substitution that is taken into account when defining the market, as discussed above. There is a suggestion that in order to be considered as part of market definition, such supply responses generally should be likely to occur within one year of the price rise (although the exact time period will depend on the nature of the market considered). In addition, such entry should not involve significant sunk investment in plant, equipment, skills, or marketing.[25] Similarly, where (i) a seller would be likely to face significant difficulty in distributing or marketing the relevant product, or (ii) new production or distribution facilities would be required to produce or sell on a significant scale, the possibility of adapting facilities may not be assessed for market definition purposes, but rather will be assessed in considering the likelihood of entry.[26] In either event, the underlying issue is to assess the extent to which the supply-side response can be expected to act as a competitive constraint on the perceived anti-competitive effects of a merger.

III. STANDARDS FOR ASSESSING THE LIKELY COMPETITIVE IMPACT OF ENTRY

A. The Likelihood That Entry Will Occur

17. In theory, a merger that results in reduced output and higher prices can attract new entry or expansion that would not have occurred at pre-merger prices. The notion is that new firms can enter or expand in the market to fill demand resulting from the

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24 Draft EC Guidelines ¶ 84. See also Case No. IV/M.1357, *Nordic Capital/Hilding Anders*, Decision of the European Commission (Feb. 4, 1999), ¶ 27.

25 See, e.g., U.K. Guidelines ¶ 2.21.

26 See, e.g., Canada Guidelines ¶¶ 3.2.2.7, 4.6.1.

merged firm's contraction in output without driving market prices below pre-merger levels. Such entry is likely to occur, however, only if firms have access to the assets they need to enter and compete and if entry would be profitable over a sustained period considering all of the costs and risks involved. In general, entry is more likely to occur where sunk costs and the risks of entry are low.

18. The likelihood of new entry is examined on a case-by-case basis, considering the structure and economic circumstances of the relevant market and the likely behavior of economically rational firms. In some jurisdictions, this analysis involves attempting to identify specific firms that would likely enter the relevant market.[27] New Zealand, for example, states that it will not attempt to identify specific firms that might enter where barriers to entry in a market are clearly low, but that where barriers are higher "the Commission may seek to identify specific businesses that might enter.[28] The guidelines of other jurisdictions (such as the draft EC guidelines) do not require that specific new entrants be identified. The U.S. guidelines state, for example, that U.S. competition authorities will assess the likelihood of new entry "without attempting to identify who might be potential entrants."[29] Even in the United States, however, identifying actual firms as likely new entrants will at the least be persuasive and may be necessary to overcome evidence tending to indicate that sufficient and timely entry would not likely occur. In practice, an otherwise anticompetitive merger may not be approved based on

27 See, e.g., Australia Guidelines ¶ 5.128.

28 New Zealand Guidelines ¶ 6.1. See also Germany Guidelines ¶ 5 ("Market entry is . . . not a firm-related, but a market-related structural criterion.").

29 U.S Guidelines ¶ 3.1.

asserted ease of entry if the merging parties fail to identify any potential entrants that can confirm that entry would likely occur.[30]

19. **More than A Mere Possibility That Entry Will Occur.** The mere possibility that entry *could* occur is not sufficient to overcome anticompetitive concerns.[31] The guidelines examined for this report variously require that entry be "likely in commercial terms,"[32] "probable . . . in concrete terms,"[33] or established to a "high probability."[34] In assessing entry, competition authorities generally consider all available evidence, including the experience of firms that have recently entered or left the market, evidence of planned entry or expansion, direct observations on the costs and risks associated with entry, the opinions of firms identified as potential entrants, and economic modeling.

20. Every jurisdiction seeks to answer the same basic question: Would a firm or firms likely enter the relevant market in response to an anticompetitive merger given all of the requirements, costs and risks of entry? Although most jurisdictions thus examine the likelihood of entry in terms of the costs and risks of entry, they employ somewhat different analytical constructs to do so.

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30 See, e.g., The Irish Competition Authority, Notice in Respect of Guidelines for Merger Analysis Decision No. N/02/004 (Dec. 16, 2002) (hereinafter, "Ireland Guidelines") ¶ 5.8 (Although "it is not necessary to identify named potential entrants, . . . [s]uch evidence would be useful if available"); Canada Guidelines ¶ 4.6.1 (will assess both "identified" and "unknown" potential entrants). See also Case No. COMP/M. 2187, CVC/Lenzig (Oct. 17, 2002) at ¶¶ 200-201.

31 See, e.g., New Zealand Guidelines ¶ 6.3.

32 Id.

33 Germany Guidelines ¶ 5.

34 Draft EC Guidelines ¶ 80. The European Commission is "unlikely to find competition concerns" when there is "strong evidence" that entry would be likely, timely, and sufficient. See also Case No. IV/330, *McCormick/CPC/Rabobank/Ostmann,* Decision of the European Commission (Oct. 23, 1993), ¶¶ 53-56 ("concrete plans").

21. **<u>Approaches Focusing On Barriers To Entry</u>.** The EU and many other jurisdictions seek to determine the likelihood of entry by assessing the existence of barriers to entry and perceived advantages enjoyed by incumbent firms versus entrants. Thus, for example, the draft EC guidelines state that, in examining the likelihood of entry, the European Commission "will have particular regard to the existence of barriers to entry to the relevant market, that is to the features of the market which may give the incumbent firms a decisive advantage over potential competitors."[35]

22. The draft EC guidelines identify three classes of barriers:

(1) *Legal advantages*, where regulatory barriers created by law limit the number of market participants, e.g., by restricting the number of licensees;[36]

(2) *Technical advantages*, such as "preferred access" to tangible and intangible assets needed to compete successfully. For example, entrants may have difficulty obtaining essential inputs, or patents might protect products or processes. "Other factors" that may constitute barriers to entry include economies of scale or scope, the need for distribution and sales networks, and access to important technologies.[37]

(3) *Strategic advantages* enjoyed by incumbent firms, such as established reputations, consumer loyalty, and close relationships with customers and suppliers. Strategic barriers also include situations where

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35 Draft EC Guidelines ¶ 80.

36 See, e.g., Case No. COMP/M.1795, *Vodafone Airtouch/Mannesmann*, Decision of the European Commission (Apr. 2000) ¶¶ 28-29.

37 See, e.g., Case No. COMP/M.2690, *Solvay/Montedison – Ausimont*, Decision of the European Commission (Apr. 9, 2002), ¶¶ 31, 63, 87-88.

entrants must invest heavily in advertising and promotion, incumbent firms already have substantial excess capacity, or customers face a high cost of switching away from incumbent suppliers.[38]

23. The draft EC guidelines and most other guidelines also consider the effect of potential responses to entry by incumbent firms,[39] whether the relevant market is growing or declining,[40] and history of entry in the industry.[41] For example, the draft EC guidelines state that entry is likely to be more difficult where incumbent firms are able closely to monitor which customers the entrant is trying to acquire and to protect their market positions by offering "targeted pre-emptive price reductions to those customers."[42] In addition, the draft EC guidelines appear to give significant probative weight to past history of entry, stating that entry "would appear to be less likely in the future" where "previous attempts . . . have been unsuccessful, perhaps due to deterring behavior by incumbents."[43]

24. The U.K., German, and Finnish guidelines are similar in structure to the draft EC guidelines, identifying classes of entry barriers and a list of factors bearing on the existence of barriers to entry.[44] The guidelines of other countries, such as those of

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38 Draft EC Guidelines ¶ 81. See, e.g., Case No. COMP/M.2544, *Masterfoods/Royal Canin,* Decision of the European Commission (Feb. 15, 2002), ¶ 55; Case No. COMP/M.2608, Decision of the European Commission, *INA/FAG* (Oct. 18, 2001) ¶ 31; Case No. COMP/M.2698, Decision of the European Commission, *Promatech/Sulzer* (Jul. 24, 2002) ¶¶ 78-80.

39 Id. at ¶ 82.

40 Id. at ¶ 83.

41 Id. at ¶ 85.

42 Id. at ¶ 82. Compare U.S. Guidelines ¶ 3.3 (The availability of sales opportunities for potential entrants may be limited by "any anticipated sales expansion by incumbents in reaction to entry, either generalized or targeted at customers approached by the entrant, that utilizes prior irreversible investments in excess production capacity").

43 Id. at ¶ 85.

44 See U.K. Guidelines at ¶¶ 3.49-3.56; Germany Guidelines ¶¶ 5.1-5.3; Finland Guidelines, 44-45.

Australia, Canada, Ireland, and New Zealand, also consider the same sorts of impediments to entry, without specifically classifying them. In all cases, analysis is framed in terms of the costs and risk of entry. Entry is considered to be unlikely when the sunk costs of entry are high and incumbent firms would likely pursue strategies designed to deter entry—e.g., by utilizing existing excess capacity, "launching predatory price or non-price initiatives,"[45] or locking up customers through long-term exclusive contracts.[46] These guidelines also highlight the importance of past history of entry and entry attempts.[47] Australia, for example, will have "particular regard to evidence of past success or failure of new entrants in establishing themselves as mainstream competitors in the relevant market."[48]

25. The guidelines of several jurisdictions also note that the merger itself may have increased the difficulty, and accordingly decreased the likelihood, of additional new entry. The U.K. guidelines, for example, state that the merger may have decreased the likelihood of new entry by "eliminating an entity which might provide an effective means of access to the market to other firms;"[49] increasing the perception by potential entrants that entry or expansion would be risky insofar as

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45 U.K. Guidelines ¶¶ 3.48. The U.S. guidelines do not consider the possibility that incumbents would engage in unlawful predatory actions to defeat new entry, but do consider the ability of incumbents to limit sales opportunities available to new entrants through output responses using existing excess capacity. See note 55, *infra*.

46 See Germany Guidelines ¶ 5.3. The U.K. Guidelines are unclear about the scale of entry that will be assumed in assessing likelihood, suggesting both that entry should be at a level to replace one or more firms in the market and that entrants should obtain a "significant share of the relevant market (usually considered as 5 percent)." See U.K. Guidelines ¶¶ 3.48, 3.56.

47 See, e.g., U.K. Guidelines ¶ 3.57; Germany Guidelines ¶ 5.4.

48 Australian Guidelines ¶ 5.128. See also Ireland Guidelines ¶¶ 5.7, 5.8; Canada Guidelines ¶ 4.6.1 ("However, the fact that entry has or has not occurred in the past does not in and of itself indicate that additional new entry would likely take place in response to a material price increase or other change in the market brought about by a merger"); New Zealand Guidelines ¶ 6.1; Finland Guidelines, 44-45. See also Baker at 20 (noting that ambiguity of evidence that entry either has or has not occurred in the past).

49 U.K. Guidelines ¶ 3.53.

the merged entity, because it is larger, more aggressively defends its market position;[50] or eliminating the most likely entrant or entrants into the market (e.g., a firm or firms operating in an adjacent market).[51]

26. **<u>The U.S. and Brazilian "MVS" Approach</u>.** The U.S. and Brazilian guidelines generally assess the same market factors bearing on the likelihood of new entry as other guidelines, but do so within a more highly specified, quantitative framework. These guidelines start with the proposition that entry would be profitable only if an entrant can secure at least pre-merger prices. Entry presumably would not occur if it would only drive prices below pre-merger prices, either because the minimum scale at which new firms would have to enter is larger than the expected merger-related reduction in output, or because incumbent firms have existing excess capacity they would use in response to attempted new entry.[52]

27. Pursuant to their guidelines, U.S. and Brazilian enforcers estimate the minimum viable scale (or MVS) of entry under various possible entry scenarios and compare it to the size of the sales opportunity available to new entrants.[53] MVS will be relatively large when the fixed costs of entry are large and largely sunk, and assets will be underutilized for a significant period of time while the new entrant attains market acceptance and grows sales.[54] As a rule of thumb, the available sales opportunity is assumed to be about five percent of total market sales, although

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50 Id. ¶ 3.54.

51 Id. ¶ 3.55.

52 U.S. Guidelines ¶ 3.3.

53 MVS is the smallest annual level of sales an entrant must achieve to cover its costs (i.e., its "break-even point"), including an appropriate rate of return on invested capital. U.S. enforcers consider as a cost of entry any introductory price discounts the entrant may need to offer to break into the market. U.S. Guidelines ¶ 3.1.

54 U.S. Guidelines ¶ 3.4.

greater or lesser sales opportunity may be used depending on the facts.[55] Thus, if MVS exceeds five percent of the market, entry may not be likely.[56]

28. A potentially key aspect of the MVS approach is its assumption that multiple entry is generally possible and that individual entrants may flexibly chose their scale of entry.[57] It is thus not assumed either that there is a single profitable entry plan, or that entry by a single firm occurring at a level below the minimum efficient level of entry is "non-optimal" entry that cannot constrain anticompetitive effects of a merger.

29. In addition, although the U.S. guidelines include recent historical entry (and exit) patterns as a "useful starting point" for understanding what is required for various entry alternatives to occur,[58] U.S. competition authorities will not assume from the mere occurrence or absence of recent entry that post-merger entry is either likely or unlikely.[59] The Brazilian antitrust authorities have adopted the same analysis.[60]

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55 Id. at n.32. Factors that might alter the five percent presumption include projected long-term growth or decline in the market, the extent of forward contracting or vertical integration by incumbent firms (which will shrink sales opportunities) or entrants (which may increase sales opportunities), the likely output response of incumbent firms to entry using existing excess capacity, and the ability of entrants to capture a share of expected growth in market demand given the "relative appeal, acceptability and reputation" of their products versus the products of incumbent firms. Id. at ¶ 3.3 and nn. 31-34. The ability of entrants to divert sales from incumbent firms in a differentiated products market where unilateral effects are of concern is addressed by U.S. authorities in considering the sufficiency of entry, discussed at paras. 30-34, infra.

56 The U.S. Guidelines have been criticized for adopting a highly quantitative methodology that is difficult to apply given the limits of reasonably available information and implies a false degree of mathematical certainty. In practice, however, MVS is not applied in this manner, and U.S. competition authorities apply a qualitative analysis very similar to that applied by the EU and other jurisdictions. Defenders of the U.S. Guidelines thus note that they provide a "fully-specified" and logically consistent approach that helps to focus the government's inquiry on the relevant factors and frame the qualitative evidence (such as the testimony of industry witnesses) to which the government (and courts) inevitably will turn. See, e.g., Baker at 19-20. See also Janusz A. Ordover & Jonathan B. Baker, *Entry Analysis Under the 1992 Horizontal Merger Guidelines,* 61 ANTITRUST L.J. 139, 145 (1992).

57 See U.S. Guidelines at ¶ 3.4. It has been suggested that the five-percent benchmark for available sales may be too high with respect to mergers raising unilateral effects concerns. See Gregory J. Werden & Luke M. Froeb, *The Entry Inducing Effects of Horizontal Mergers: An Exploratory Analysis*, 46 INDUS. ECON. 525 (1998).

58 Id. at ¶ 3.1.

59 See Baker at 20-21.

60 See Brazil Guidelines ¶ 45.

B. THE SUFFICIENCY OF NEW ENTRY

30. Virtually all of the guidelines surveyed for this report recognize that entry must also be sufficient in its nature, magnitude, and scope effectively to deter or counteract anticompetitive effects.[61] As stated in the New Zealand guidelines, "if the only viable entry occurs at the fringe of the market, and fails to attack the incumbent's core business, then entry cannot be seen as being an effective constraint."[62] In other words, new entrants must be capable of diverting sufficient sales from incumbent firms to make any attempted anticompetitive price increase by them unprofitable. This proposition drives analysis of the likely sufficiency of new entry.

31. In most jurisdictions, analysis of the sufficiency of entry is closely related to analysis of the likelihood of new entry, and the guidelines provide little additional guidance regarding analysis of sufficiency. [63]

32. Under the U.S. guidelines, entry that is deemed to be likely is assumed also to be sufficient, with two exceptions: (a) where incumbent firms can limit entrants' access to key assets needed for entry at competitive levels; or (b) where entrants are unable to respond to localized competitive effects of the merger, *viz.* in mergers in differentiated product markets characterized by unilateral effects.[64]

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61 See, e.g., U.S. Guidelines ¶ 3.0 (entry must be "sufficient in its magnitude, character and scope to deter or counteract the competitive effects of concern"); New Zealand Guidelines ¶ 6.3 ("if it is to constrain market participants, the threat of entry must be at a level and spread of sales that is likely to cause market participants to react in a significant manner"); Draft EC Guidelines ¶¶ 79, 86 (entry must be "sufficient in its magnitude and scope"); U.K. Guidelines ¶ 3.45 (entry must be "likely to have an impact"); Australia Guidelines ¶ 5.126 (entry must be "on a sufficient scale and . . . offer a product sufficiently attractive for consumers to be effective"); Canada Guidelines ¶ 4.1 ("sufficient entry" must occur to "ensure that a material price increase would not likely be sustainable in a substantial part of the relevant market"); Finland Guidelines p. 43.

62 New Zealand Guidelines ¶ 6.2, citing Prof. M. Brunt, "Australian and New Zealand Competition Law and Policy," 19th Fordham Conference on International Antitrust Law and Policy (1992), 31.

63 The U.S. guidelines, for example, explicitly state, "committed entry generally will be sufficient . . . whenever entry is likely . . . ." U.S. Guidelines ¶ 3.4. Other guidelines do not separately discuss the criteria for determining sufficiency, but assume in assessing likelihood that new entrants would have to achieve a certain scale and scope in order to be profitable and competitive. See, e.g., Canada Guidelines ¶ 4.6.1.

64 See U.S Guidelines ¶ 3.4.

33. Other jurisdictions similarly provide that, even entry that would be profitable may not be *sufficient* if the amount of business the new entrant or entrants can contest would be so small or so isolated that incumbent firms could still profitably raise prices to a significant portion of the market. This might be the case for a number of reasons. For example, a new entrant nevertheless may lack sufficient access to assets required to achieve the level of sales needed to discipline incumbent firms.[65] It may be geographically limited. Or, its products may lack the quality or other attributes needed to attract a significant number of customers. New Zealand, for example, "is of the view that entry that might occur only at relatively low volumes, or in localized areas, is not likely to represent a sufficient constraint to alleviate concerns about a lessening of competition."[66] Such "niche," or fringe, entry is generally considered to be insufficient to constrain the anticompetitive effects of a merger.[67]

34. Entry also must be sufficient to deter or counteract the specific competitive effect of concern. Where the likely competitive effect of the merger is not uniform across the relevant market, the new entrant must be able to respond to the localized anticompetitive effects. For example, if the competitive effect of concern would be geographically isolated, the new entrant must be able to respond to demand within the geographic area of concern.[68] Or, where the competitive concern is a unilateral price increase resulting from a merger between producers of differentiated

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65 See, e.g., U.S. Guidelines ¶¶ 3.0, 3.4 ("constraints on availability of essential assets, due to incumbent control, [may] make it impossible for entry profitably to achieve the necessary level of sales").

66 New Zealand Guidelines ¶ 6.3. See also U.K. Guidelines ¶ 3.52 ("entry of firms producing niche products will not necessarily constrain incumbent firms' ability to exercise their market power"); Draft EC Guidelines ¶ 86 ("entry into some market 'niche' may not be a credible constraint").

67 See, e.g., Draft EC Guidelines ¶ 86; New Zealand Guidelines ¶ 6.2.

68 See New Zealand Guidelines ¶ 6.3.

products, the new entrant must be able to offer a product that is directly competitive with the merging firms' products and sufficiently attractive that a substantial number of the merged firms' customers would switch to it in response to an anticompetitive price increase.[69]

C. TIMELINESS OF ENTRY

35. An important aspect in assessing entry conditions involves determining the time it would take for a potential competitor to respond to a material price increase or other change in the market brought about by a merger and become an effective competitor.[70] There is general agreement among the guidelines that the relevant time period must be short enough to deter or counteract the merged entity from exploiting its market power.[71]

36. The majority of merger guidelines consider that effective entry is that which is likely to have an impact on the market within a two-year period, although this may vary according to the circumstances.[72] This time scale implies the recognition that potential entrants require more time than firms already operating on the relevant market—who are typically identified on the basis of a one year response time—to learn about and assess new opportunities, develop products and marketing plans, build facilities, qualify as acceptable sources of supply for buyers, and achieve a sufficient level of sales to prevent or eliminate a material price increase.[73]

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69 See U.S. Guidelines ¶ 3.4; Ireland Guidelines ¶ 5.5.

70 *See, e.g.,* Canada Guidelines ¶ 4.6.2.

71 See, e.g., Draft EC Guidelines¶ 86; Germany Guidelines at ¶ 5; U.S. Guidelines ¶ 3.2.

72 *See, e.g.,* Australia Guidelines ¶ 5.126; Canada Guidelines ¶ 4.6.2; Ireland Guidelines ¶ 5.3; New Zealand Guidelines ¶ 6.3; U.S. Guidelines ¶ 3.2.

73 See, e.g., Canada Guidelines ¶ 4.6.2.

37. Most of the merger guidelines surveyed for this report agree that what is considered as an adequately short period will vary according to the circumstances, dynamics, and characteristics of the relevant market. The relevant time period may be shorter or longer, depending on the special features of a given market.[74] For example, in markets where goods and services are supplied and purchased on long-term contracts, buyers may not immediately be exposed to the anticompetitive effects of a merger. In such cases, the competition analysis in regard to the relevant time period to be considered generally begins from the time when these contracts come up for renewal.[75] As further example, where the relevant product is a durable good, consumers may defer purchases by making additional investments to extend the life of previously purchased goods that may then cause entry to take place over a longer period. In such markets, entry does not need to occur as swiftly to be effective.[76]

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74 See, e.g., Draft EC Guidelines ¶ 86; Ireland Guidelines ¶ 5.3. Although the draft EC Guidelines do not specify a time limit, in general, a five-year period clearly falls outside the time frame used by the European Commission to assess the impact of potential entry on a proposed merger. Case No. COMP/M.1693, *Alcoa/Reynolds*, Decision of the European Commission (May 3, 2002), ¶ 31.

75 See, e.g., New Zealand Guidelines ¶ 6.3.

76 See, e.g., U.S. Guidelines ¶ 3.2; Australia Guidelines ¶ 5.127.

Annexe: Overview of Basic Approaches to Entry in Selected Jurisdictions

Australia -- Australian Competition and Consumer Commission, Merger Guidelines, June 1999

Responses that Qualify as Entry	Guidelines provide that sunk costs (costs unrecoverable upon exit) place entrants at a disadvantage. Implies consideration of committed entry, as opposed to simple supply side substitution.
Sources of Entry Considered	Not addressed in guidelines.
Likelihood	Sunk costs must permit entry to exist on an efficient and competitive scale for it to be sufficiently likely.
Sufficiency	Whether post-entry prices will support sufficient entry depends on the minimum efficient scale of entry, cost penalties associated with sub-optimal plant utilization, price elasticity of demand and market growth.
Timeliness	Entry is timely if it is likely to have a market impact within a two-year period.
Standard Employed	There must be real pressure on established firms' profits for entry to be easy.
Other Factors	Minimum efficient scale of operation considered by Commission in evaluation of barriers to entry.

Brazil – SEAE/SDE Joint Resolution No. 50, Guidelines for the Analysis of Horizontal Merger Concentration, August 1, 2001

Responses that Qualify as Entry	Responses ranging from committed entry to supply-side substitution are considered in entry analysis.
Sources of Entry Considered	Expansion of production facilities (existing capacity); capacity expansion (new capacity); entry of new competitors onto the relevant product market; supply-side substitution or adaptation of existing facilities by firms in adjacent markets.
Likelihood	Entry is sufficiently likely when it is economically profitable at pre-merger prices (i.e. minimum scale does not exceed sales opportunities at pre-merger prices.)
Sufficiency	Entry is considered sufficient when it allows all sales opportunities created by the merger to be exploited by potential entrants.
Timeliness	Entry of a potential competitor into the market within two years may be sufficient.
Standard Employed	The probability of exercising market power is practically non-existent when new entry is "easy" and "sufficient."
Other Factors	Barriers to entry are not ranked in order of importance.

Canada -- Merger Enforcement Guidelines, Competition Bureau, March 1991

Responses that Qualify as Entry	Guidelines' examination of sunk costs in assessment of entry impediments implies consideration of committed entrants.
Sources of Entry Considered	Establishment of new production facilities by existing competitors; supply-side substitution by firms in adjacent markets; potential new competitors.
Likelihood	More likely where there are firms with an inherent advantage (i.e. fringe firms already in the market, firms in adjacent geographic markets, firms that use similar or related facilities, firms that sell in related upstream or downstream markets and firms that sell through similar distribution channels or employ similar marketing or promotional methods).
Sufficiency	The scale of the new entrant must be sufficient to ensure that a material price increase, or other change brought about in the relevant market by the merger, could not be sustained for more that two years
Timeliness	Must be achieved in within two years.
Standard Employed	New entry is more likely to occur when a market is in its growth stage than when it is stagnating or declining.
Other Factors	Entry is considered where, as a result of new entry, a material price increase would not likely be sustainable in a substantial part of the relevant market for more than two years.

European Union – Draft European Commission Notice on the Appraisal of Horizontal Mergers Under the Council Regulation on The Control of Concentrations Between Undertakings, COM (2002), December 11, 2002, Adopted by the European Commission on December 16, 2003 [To Be Effective May 1, 2004]

Responses that Qualify as Entry	Entry is considered to be particularly likely if suppliers in other markets already possess production facilities that could be used to enter the market, i.e. reallocation of production facilities.
Sources of Entry Considered	The most realistic and potential competition comes from the expansion of capacity by established competitors.
Likelihood	There must be a high probability of success.
Sufficiency	Entry that might occur only at relatively low volumes, in localized areas, or in "niche" products generally will not represent a sufficient constraint to alleviate concerns about market power.
Timeliness	No hard deadline – timeliness depends on the characteristics and dynamics of market, and on the capabilities of potential entrants -- must be sufficiently quick and persistent to prevent the exercise of market power.
Standard Employed	It is not likely that the Commission will find barriers to entry in an industry that has experienced frequent and successful examples of entry.
Other Factors	The likely evolution of the market should be taken into account when assessing whether or not entry would be

	profitable.

Finland -- Finnish Merger Guidelines, September 15, 1998

Responses that Qualify as Entry	Undertakings already present in the market may pose a threat of potential competition if they have a possibility to increase their production, i.e. supply-side substitution.
Sources of Entry Considered	Potential competition from market participants that may increase production, or from participants in adjacent product or geographic markets that may alter production or expand their geographical scope are taken into account.
Likelihood	In order to be sufficiently likely, entry must be "economically rational."
Sufficiency	Entry must be sufficient and likely to defeat any attempts by the combined firm to exercise market power.
Timeliness	Entry must occur within a reasonably short timeframe.
Standard Employed	Barriers do not need to block entry completely for an indefinite period for market power to succeed. It is sufficient that they delay or restrict entry during a period of time that is significant in relation to functioning competition.
Other Factors	The significance of potential competition depends on whether entry is possible, economically rational, and whether is it so extensive and rapid as to prevent the use of market power.

Germany -- Bundeskartellamt General Policy Division, The Principles of Interpretation, October 2000

Responses that Qualify as Entry	Guidelines focus on barriers to entry rather than competitor or potential competitor responses.
Sources of Entry Considered	Potential foreign and domestic competitors are considered, however foreign firms may face additional barriers in particular markets.
Likelihood	Entry must be possible and probable; and it must be possible to express in sufficiently concrete terms.
Sufficiency	Entry will be sufficient if it counteracts or prevents the use of market power by the merged firm.
Timeliness	The time period must be short enough to dissuade the merged entity from exploiting its market power.
Standard Employed	High barriers to entry need not completely exclude the possibility of others entering the market for market power to succeed. Entry barriers will be considered where it is unlikely that entry will be sufficient to counteract the market power of the merged firm.
Other Factors	Entry will be considered a constraint on anticompetitive post-merger effects when it is probable, timely and will occur at a quantity, price and scale sufficient to counteract an anticompetitive price increase. Markets working to full capacity with good customer relations provide little incentive for potential competitors to enter.

Ireland – The Competition Authority, Notice in Respect of Guidelines for Merger Analysis, December 16, 2002

Responses that Qualify as Entry	Not addressed in guidelines.
Sources of Entry Considered	Not addressed in guidelines.
Likelihood	Entry is sufficiently likely if it would be profitable at existing prices.
Sufficiency	To be of sufficient scope, the new entrant must be able to respond to localized sales opportunities, and must be able to return prices to their pre-merger levels, and thus deter the merged firm from raising prices.
Timeliness	Entry is considered timely only if it would occur within two years.
Standard Employed	The burden of showing that entry will ameliorate the effects of any competitive concerns relating to the merger rests with the merging parties.
Other Factors	The efficient scale of the entrant is considered, as is evidence of past successful entry into the market.

Japan -- Guidelines for Interpretation on the Stipulation that "The Effect May Be Substantially to Restrain Competition in a Particular Field of Trade" Concerning M&As, 1998

Responses that Qualify as Entry	Not addressed in guidelines.
Sources of Entry Considered	Companies that can supply the goods without major alteration of production facilities, and entry into the domestic market by foreign companies will be considered.
Likelihood	Not addressed in guidelines.
Sufficiency	Not addressed in guidelines.
Timeliness	Not addressed in guidelines.
Standard Employed	The turnover of competitors, increases or decreases in the number of competitors and other changes and the trends in the top-three firm concentration ratio are considered to determine the extent of entry barriers.
Other Factors	Legal restrictions on entry are considered along with minimum funding requirements, geographic scope of the market, specialized technical knowledge requirements, the availability of raw materials, and other general conditions of the market.

New Zealand -- New Zealand, Commerce Commission, Mergers and Acquisitions Guidelines, January 1, 2004

Responses that Qualify as Entry	Guidelines' examination of sunk costs in assessment of entry impediments implies consideration of committed entrants.
Sources of Entry Considered	New competitors coming onto the market with new capacity, new competitors that take over existing capacity, altering production or geographical range of activity to meet consumer needs, or adaptation of existing facilities or technologies are recognized as potential sources of new entry.
Likelihood	The mere possibility of entry is an insufficient constraint on the exercise of market power. Entry must be likely in commercial terms (i.e. entrants must have a reasonable prospect of achieving a satisfactory investment return).
Sufficiency	The threat of new entry must be at a scale and scope that would cause market participants to react in a significant manner. Entry that might occur only at relatively low volumes, or in localized areas is not considered to represent a sufficient constraint to alleviate concerns about market power.
Timeliness	Entry must be likely to have an impact on the market within a two-year period.
Standard Employed	The overall obstacle to entry posed by the aggregation of the various barriers is relevant in determining whether entry is relatively easy or not, and therefore whether potential entry would prevent a substantial lessening of competition.
Other Factors	The threat of market entry or expansion can constrain the post-merger exercise of market power if it is likely, sufficient in extent and timely (the *let* test).

Romania -- Guidelines on Relevant Market Definition With A View To Determining the Significant Market Share, March 21, 1997

Responses that Qualify as Entry	Guidelines address relevant market definition only.
Sources of Entry Considered	Not Applicable
Likelihood	
Sufficiency	
Timeliness	
Standard Employed	
Other Factors	

United Kingdom -- United Kingdom, Merger References: Competition Commission Guidelines, June 2003

Responses that Qualify as Entry	Entry typically requires investment in production assets and takes longer to establish than supply-side substitution.
Sources of Entry Considered	Existing firms that build new capacity are a potential new source of entry. Other sources include new competitors, and backward or forward integration.
Likelihood	Factors affecting likelihood include the costs of unsuccessful entry and the probability that incumbent firms will pursue strategies designed to deter entry.
Sufficiency	To be sufficient, entry must have impact on the potential for existing firms to exercise market power.
Timeliness	No hard deadline; must be achieved within a timetable that bears on the incentives and decisions of the incumbents.
Standard Employed	A substantial lessening of competition as a result of a merger is unlikely where entry is easy.
Other Factors	In considering historical evidence, relevant factors include survival rates and the effects that entry or expansion had on competition in the market (i.e. whether it had an impact on the competitive landscape).

United States -- 1992 Horizontal Merger Guidelines

Responses that Qualify as Entry	Guidelines' focus is on committed entrants with expenditure of significant sunk costs.
Sources of Entry Considered	Incumbent expansion, or using prior irreversible investments in excess production capacity.
Likelihood	Entry is likely if it would be profitable at pre-merger prices, and unlikely if the minimum viable scale is greater than likely sales opportunities.
Sufficiency	Where an incumbent controls required assets, entry would not be sufficient to return market to pre-merger prices.
Timeliness	Two years from planning to significant market impact.
Standard Employed	Where entry would be timely, likely and sufficient, a merger raises no antitrust concerns and ordinarily requires no further analysis.
Other Factors	Specific potential entrants do not need to be identified. However, recent examples of entry, successful or unsuccessful, may provide a useful starting point for identifying the necessary actions, time requirements, and characteristics of possible entry alternatives.

POSTSCRIPT

The European Commission (EC) has since adopted final Guidelines on the assessment of horizontal mergers, accompanying the amended EC Merger Regulation, which shall enter into force on 1 May, 2004.[77] Structuring the entry analysis more clearly around the three sub-headings likelihood, sufficiency and timeliness, the EC reiterates that the entry analysis is an important element of its overall competitive assessment of mergers. When examining the likelihood of entry, the EC takes the view that the central issue is whether entry would be sufficiently profitable taking into account the price effects of injecting additional output into the market and the potential responses of incumbents. It describes in familiar terms the various forms of barriers to entry. However, it now appears to downplay the importance of the record of entries, stating that past examples of entry and exit may provide "useful" information about the size of entry barriers.[78] The draft Guidelines had suggested that the EC would give more significant probative weight to past history of entry.

In regard to the timeliness of entry, the EC Guidelines indicate that entry is normally considered timely if it occurs within two years, although it emphasizes that the appropriate time period will depend on the characteristics and dynamics of the market.[79]

77 Article 2(3) of the Council Regulation (EC) No 139/2004 of 20 January 2004 on the control of concentrations between undertakings [2004] O.J. L 24/1, available at http://europa.eu.int/eur-lex/pri/en/oj/dat/2004/l_024/l_02420040129en00010022.pdf.

78 EC Guidelines at ¶ 70.

79 EC Guidelines at ¶ 74.

CHAPTER 6 - EFFICIENCIES[1]

OVERVIEW

In this chapter, the authors review the approaches of the various competition authorities in twelve different jurisdictions with respect to merger efficiencies. As a general observation, we note that no one modality for the treatment of merger efficiencies is necessarily correct or appropriate for all countries. The treatment of merger efficiencies will vary depending on a number of factors, including the nature of the particular economy in question, the degree to which it is integrated with the economies of other trading nations, its historical economic experience with competition and competition law, the goals of its competition law and the economic theory background, the extent of regulation and deregulation, and its size. What should be consistent among nations, however, is a recognition of the role that mergers play in the promotion of economic growth and development and the importance of taking merger efficiencies into account, either implicitly or explicitly.

A merger that enhances a merged firm's market power and increases prices generally results in a reduction in allocative efficiency[2] and the creation of "dead-weight loss", as consumers consume less-valued substitutes or forgo consumption and producers produce a less than socially optimal level of output. A "transfer of wealth" is also created when consumers continue to purchase the product or service at prices higher than they would have under more competitive conditions. In this sense their wealth is notionally "transferred" to producers, sellers and/or their shareholders.[3] However, in some jurisdictions, the wealth transfer itself may be seen as presumptively socially harmful, regardless of its economic effect.

Efficiencies generated by a merger can also have the effect of increasing consumer and/or producer/seller welfare due to the ability of the merged firm to provide its products or services at lower prices (or better quality) and/or at lower costs, resulting in an overall benefit to society. In fact, significant variable cost savings can result in lower prices, despite a lessening of competition. (Even fixed cost savings may lead to future price reductions.) A merger may also create dynamic efficiencies through the creation of new products or innovations. Moreover, there may be resource savings to other parts of the

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1 Calvin Goldman and Michael Piaskoski (Blake, Cassels & Graydon LLP, Canada); Tony Woodgate and Oliver Gilman (Simmons & Simmons, England); Bob Baxt, Melissa Randall and Susannah Downie (Allens Arthur Robinson, Australia); and Ilene Knable Gotts (Wachtell, Lipton, Rosen & Katz, U.S.A.). The authors wish to thank Mauro Grinberg and André Marques Giberto (Araújo & Policastro Advogados, Brazil), Jochen Burrichter and Axel Beckmerhagen (Hengeler Mueller, Germany), Riki Nakato (Hibiya Sogo Law Offices, Japan), Professor Peter Townley (Acadia University, Canada), Professor Tim Hazeldine, (University of Auckland, New Zealand), and Brian Facey and Crystal Witterick (Blake, Cassels & Graydon LLP) for their valuable contributions.

2 "Allocative efficiency" occurs when goods and services are consumed and produced so that society's resources are allocated to their most valued use in production and consumption. This occurs when goods and services are priced at marginal cost. In the absence of external costs and benefits (externalities), a perfectly competitive market maximises allocative efficiency and thus the sum of consumer surplus and producer surplus. There is no dead-weight loss when allocative efficiency is achieved. (The foregoing applies *mutatis mutandis* to the case of merging firms acquiring buying power, which would result in lower-than-competitive prices but similar dead-weight losses.)

3 Such a transfer may also reduce efficiency to the extent that the transfer is used by producers to purchase exclusionary rights (*i.e.*, to create or raise barriers to entry). *See* Richard A. Posner, *Economic Analysis of Law*, 258 (3d ed. 1986) "If a monopoly or cartel has any expected monopoly profits, that expectation will induce firms to expend resources on forming and maintaining monopolies and cartels and, once they are formed (in the case of cartel), on engrossing as large a proportion of the sales of the market as possible through non-price competition. These resources will be (largely) wasted from a social standpoint."

economy, quite apart from the benefits to the consumers and producers directly affected by the merger, for example, those resulting in increased R&D activities. Productive and dynamic efficiencies are often primary rationales for mergers and are critically important for the creation of long-term economic growth and welfare.[4]

Although several competition authorities may consider the possibility of efficiencies being generated by a merger, many require the parties to produce considerable evidence to substantiate the likelihood and magnitude of their claimed efficiencies and to show that such efficiencies will be passed on as benefits to consumers in some reasonable time frame. Further, there appears to be inconsistency among the authorities as to how to treat merger efficiencies, including how they should be factored into merger review, what kinds of efficiencies should be considered, and whether efficiencies should be discounted as post-merger market shares approach uncomfortably high levels.

Efficiencies are most likely to be given less weight when the likely adverse competitive effects are substantial. Competition authorities are also likely to take the position that efficiencies almost never justify a merger to monopoly or near-monopoly. The challenge is to balance the cost of taking merger efficiencies into account against the cost of preventing mergers that are socially beneficial because of the efficiencies they generate. A key issue is whether competition authorities should rely on presumptions or proxies (*i.e.*, low market shares) or whether they should examine merger-specific efficiency claims on a case-by-case basis.

The authors posit that, although there is a need for competition authorities to work toward adopting consistent approaches to merger efficiency claims in an increasingly global economy, there is no one-size-fits-all solution and, depending on the state of development of a jurisdiction's economy, a greater acceptance of and reliance on efficiencies may be warranted. This requires that competition authorities have the option to examine and consider claims of credible productive, dynamic and other less-accepted types of efficiencies, as well as a clear direction on how to treat the redistributive effects that might be associated with such mergers.

4 *See* Joseph F. Brodley, "The Economic Goals of Antitrust: Efficiency, Consumer Welfare, and Technological Progress" (1987) 62 N.Y.U. L. Rev. 1020 ("**Brodley**"), noting, among other things, the efficiency benefits of competition and the importance of innovation efficiencies.

I. INTRODUCTION

1. A June 1994 OECD *Interim Report on Convergence of Competition Policies*[5] states that: "There is general consensus that the basic objective of competition policy is to protect and preserve competition as the most appropriate means of ensuring the efficient allocation of resources – and thus efficient market outcomes – in free market economies. While countries differ somewhat in defining efficient market outcomes, there is general agreement that the concept is manifested by lower consumer prices, higher quality products and better product choice." The Report notes further that, although the competition laws of some countries encompass other objectives as well, it is clear that the efficiency goal is central to competition enforcement in virtually all Member countries.

2. Mergers, joint ventures, and strategic alliances, unlike naked price-fixing arrangements, involve the integration of resources; hence, they have the ability to generate real efficiencies. However, there are differing views on the role that efficiencies should play in the competitive analysis of merger transactions. Importantly, the focus of competition policy on the treatment of efficiency claims in some jurisdictions and the fundamental rejection of possible efficiency claims in other jurisdictions has not always been clearly understood or delineated. Many competition authorities have taken a structuralist approach that focuses on the increase of market power. In some jurisdictions, market shares are used as a proxy to assess market power. Indeed, in some cases, courts and enforcement authorities viewed efficiencies as a negative factor to be counted *against* a merger, as they could add to the market dominance of the merging parties.

3. In addition to the issues facing competition authorities, there is also a difficult burden facing the parties to a merger who seek to argue the pro-competitive efficiency-enhancing elements of a transaction. The parties must define and demonstrate the size and nature of anticipated efficiencies, often at a very preliminary stage in their due diligence and business planning, and certainly before they have the opportunity to fully assess the reality of the integration challenges they may face. While in most jurisdictions there is now a highly-developed paradigm for the analysis of anti-

5 OECD/GD (94) 64, at Annex, Areas of Convergence in Competition Policy and Law at ¶ 4.

competitive effects (*i.e.*, assessing the relevant markets, market shares and barriers to entry), the paradigm for considering specific merger efficiencies is rejected or relatively undeveloped in many countries. Accordingly, competition authorities may seek to discount the magnitude of predicted efficiencies.

4. In this context, it is not surprising that there are very few merger cases where a merger enforcement decision has turned explicitly on the efficiency-enhancing attributes of the transaction.

5. Clearly, some jurisdictions, such as the U.S., Canada, the EU, the U.K. and Australia, have developed policies on the treatment of efficiencies and continue to refine their policies today.[6] Many jurisdictions today have issued legislation, statements or guidelines that appear more receptive to incorporating efficiencies into the analysis and viewing the achievement of efficiencies as a potentially positive outcome of a transaction. In practice, however, there appears to remain a degree of hesitancy in finding that efficiencies will offset concentration presumptions in most cases. At the core of all of these issues — and influencing the attitude of competition authorities and the courts — is the underlying normative perspective toward welfare redistribution policies.

6. A transaction that provides a firm with market power[7] generally results in a reduction in allocative efficiency (increased dead-weight loss). However, efficiencies generated by the transaction may have the effect of increasing consumer and/or producer welfare due to the ability of the merged firm to offer the relevant product or service at a lower price (or better quality) and/or lower cost. Some commentators and scholars suggest that a transaction would be net beneficial and should not be blocked so long as it increases the sum of consumer and producer surplus. Such an approach is indifferent as to whether the transaction benefits producers at the expense of consumers, so long as resources saved (the "efficiencies") exceed the resulting dead-weight loss due to increased market power. In contrast, in a consumer-focussed approach, a transaction may be prohibited if, on balance, consumers are harmed.

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6 For a detailed discussion of the treatment of efficiencies in the U.S., EU and Canada*, see* Ilene Knable Gotts and Calvin S. Goldman "The Role of Efficiencies in M&A Global Antitrust Review: Still in Flux?" (2002) Fordham Corp. L. Inst. (B. Hawk, ed. 2003) at 201-300 ("**Gotts & Goldman**").

7 In this context, market power can be described as the ability to profitably maintain prices above competitive levels for a specified period of time. A merger leads to an increase in market power if it leads to higher prices (or other disadvantages) to consumers. The relevant benchmark in this respect is the market situation which would apply in the

Indeed, in many jurisdictions, it appears necessary that efficiency gains must be passed on, at least in part, to the customers of the merged parties. Thus, such an approach can limit significantly the types of efficiencies that will be given any weight in a merger review. For example, while variable cost savings translate into reduced marginal costs and are likely to be passed on to consumers through reduced prices, fixed cost savings are not (at least in the short term); they are independent of prices to customers even though they may represent real resource savings to the economy. Other commentators and scholars suggest that a direct welfare-based evaluation of mergers should not be conducted at all.

7. Moreover, in transactions involving high concentration levels, merger parties often find themselves faced with a presumption of illegality that is very difficult to overcome.

8. The treatment of efficiencies varies among industrialised nations. Competition authorities and most courts have considered efficiencies to different degrees, including hostility[8], disregard, healthy scepticism or cautious hesitancy, as a defence or as a factor contributing to market dominance. This divergence in merger efficiency policies among enforcement regimes can have an adverse effect on the ability of firms to merge or undertake acquisitions (or, for that matter, compete) on an international basis.[9] Increasingly, markets are operating on a global scale — or at least with the same multinational firms trading or operating in many jurisdictions. As the marketplace continues to evolve globally, convergence and/or harmonisation among the major enforcement authorities on fundamental competition issues such as the role of merger efficiencies will provide firms with a greater degree of certainty.

9. In all jurisdictions, there exist several difficult and determinative policy questions surrounding the implementation of appropriate rules to take efficiencies into account, including: (1) whether and how efficiencies should be factored into the merger analysis; (2) what type of efficiencies should be given any weight; (3) what welfare standard should be applied; (4) what standard of proof should be imposed;

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absence of the merger.

8 Examples of early hostility in the U.S. can be found in the cases of *Brown Shoe Co. v. United States*, 370 U.S. 294, at 344 (1962), *United States v. Philadelphia National Bank et al.*, 374 U.S. 321 (1963), *FTC v. Proctor and Gamble Co.*, 386 U.S. 568 at 580 (1967) and *FTC v. Foremost Dairies*, 60 F.T.C. 944 (1962).

9 Gotts & Goldman at 203.

(5) whether efficiencies can save otherwise anti-competitive mergers with potentially large post-merger market shares; and (6) what the paramount goal of the merger regime is.

II. HOW ARE EFFICIENCIES TREATED IN MERGER REVIEW?

10. An important policy question is how efficiencies should be incorporated into the review of a merger by a competition authority. For example, they may be simply ignored (as in many jurisdictions, including the early years of the U.S. Clayton Act), they may be factored into the overall competition assessment of the merger, or they may be used as a defence to rebut a finding of an anti-competitive merger. The discussion below presents some of the methods used by the jurisdictions reviewed.

(a) Efficiencies as part of an SLC or dominance test

11. The consideration of efficiencies may be incorporated into the analysis of a substantial lessening of competition (**SLC**). On this basis, a merger that reduces or prevents competition, but generates significant efficiencies, might be permitted where efficiencies have rendered the lessening of competition insubstantial or where they are large enough to cause a price decrease despite the lessening of competition. This is generally the position adopted in the United States.[10]

12. The new merger guidelines of the UK Office of Fair Trading under the *Enterprise Act 2002* (**UK OFT Merger Guidelines**)[11] allow the OFT to take efficiency gains into account at two separate points in the analytical framework. First, efficiencies may be taken into account where they increase rivalry in the market so that no SLC would result from a merger.[12] Second, efficiencies might also be taken into account where they do not avert a SLC, but will nonetheless be passed on after the merger in the

10 Whether efficiency considerations are part of an SLC test depends on what that test means, and there are important differences in how the test is applied in different jurisdictions. For instance, in the UK, the SLC test is understood to refer to the competitive process. In the U.S., the test is understood to refer to the outcome of that process, so the SLC test is the only possible way of incorporating efficiencies. While the outcome matters in the UK, it is in a quite distinct part of the analysis. Further, some jurisdictions have two separate welfare analyses with different welfare measures, applied at different stages of merger review or by different enforcement agencies. Moreover, efficiencies may always be considered a "defence" in the sense that the merging parties will always have some burden of persuasion (but never in the sense that their presence will make anti-competitive effects irrelevant).

11 "Mergers: **Substantive assessment guidance" (May 2003)** , *available at:* **http://www.oft.gov.uk/NR/rdonlyres/283E1C2D-78A6-4ECC-8CF5-D37F4E4D7B22/0/oft516.pdf**.

12 For example, this could happen where two of the smaller firms in a market gain such efficiencies through merger that they can exert greater competitive pressure on larger competitors. UK OFT Merger Guidelines at ¶4.30.

form of customer benefits.[13]

13. The new merger guidelines of the UK Competition Commission (**UK CC Merger Guidelines**)[14] also focus on whether efficiencies will enhance rivalry among the remaining firms in the market and therefore prevent an SLC from occurring. Thus, where efficiency gains are claimed to have a positive effect on rivalry, it can be said that their impact is assessed as part of the SLC analysis.[15]

14. The New Zealand Commerce Commission (**NZCC**) has published a Practice Note[16] (**NZ Practice Note**) that identifies a number of issues, including efficiencies, that the NZCC may consider in determining whether a proposed acquisition would result in an SLC. While efficiencies are generally considered under the New Zealand authorisation procedure, they may also be relevant in clearance applications where, as a result of these efficiencies, an acquisition could be seen to have an overall "pro-competitive" effect. It is not clear from the NZ Practice Note whether efficiencies are considered as part of the total assessment of the effect on competition under an SLC analysis, or whether they might operate as a defence to a merger that is otherwise anti-competitive. Mergers that would or would be likely to result in an SLC in a market may nevertheless be authorised if the NZCC is satisfied that the public benefits outweigh the detriment arising from any SLC. The NZ Practice Note states that "[w]here the applicant can make a sound and credible case that such efficiencies will be realised, that they cannot be realised without the acquisition, and that they will enhance competition in the relevant market, the [NZCC] will include them in the broader analysis of all of the competitive effects of the acquisition in assessing whether or not competition is likely to be substantially lessened".[17]

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13 For example, if a merger would reduce rivalry in a market but proven efficiencies would be likely to result in lower prices to customers, the OFT would not take this into account in reaching a conclusion on the SLC test, but it might be a consideration under the customer benefits exception to the duty to refer to the UK CC. *Id. a*t ¶4.3.

14 Merger References: Competition Commission Guidelines (March 2003) at ¶3.26, ***available at*** http://www.competition-commission.org.uk/our_role/consultations/past/pdf/ebmerg.pdf.

15 Examples where efficiencies may enhance rivalry among the remaining players in the market include the case where two smaller firms merge to provide more effective competition to a larger rival, or where the merger stimulates the combined firm to invest more in R&D and thereby increase rivalry through innovation.

16 "The Commission's Approach to Adjudicating on Business Acquisitions Under the Changed Threshold in Section 47 – A Test of Substantially Lessening Competition", ***available at:*** http://www.comcom.govt.nz/publications/GetFile.CFM?Doc_ID=303&Filename=pnote428may01.pdf.

17 The NZ Practice Note also suggests that efficiencies may only be used to defend a claim that a proposal will substantially lessen competition: "[t]he Commission envisages that efficiency claims of the required magnitude and credibility will only rarely overturn a finding that competition would otherwise be substantially lessened."

15. The Australian Merger Guidelines[18] recognise that mergers are one means by which domestic firms exposed to global markets can achieve efficiency. The Guidelines note that the Australian *Trade Practices Act 1974* (**TPA**) is concerned with the lessening of competition in a market, not with the competitiveness of individual firms. It states, however, that an acquisition that increases the competitiveness of the merged firm may also increase competition in the market. In the context of an informal clearance, efficiencies are relevant to the extent that they impact the level of competition in the market. The Australian Competition and Consumer Commission (**ACCC**) states that, rather than being considered as a "trade off" with competition effects, as might be done in an authorisation context, the concern in a merger analysis is the effect or likely effect on the combined firm's abilities and incentives to compete in the relevant market, including any effect flowing from efficiencies.

16. Efficiencies are also considered as part of an overall SLC or dominance test in Finland[19] and Japan[20]

17. Article 2(3) of the European Community Merger Regulation (**ECMR**)[21] provides that a "concentration which would not significantly impede effective competition, in the common market or in a substantial part of it, in particular as a result of the creation or strengthening of a dominant position, shall be declared compatible with the common market." As efficiencies may make the merged entity more competitive, efficiency considerations can be part of the overall competition assessment under Article 2 of the ECMR.

18. In particular, Article 2(1)(b) of the ECMR contains a detailed list of the factors that

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18 Merger Guidelines (June 1999), *available at* http://www.apeccp.org.tw/doc/Australia/Decision/merguide.html

19 Juhani Jokinen notes that, "(a)n increase in efficiency may, however, be attached which supports the approval of the concentration. Increased efficiency may, *e.g.*, consist of the achieving of synergy or economies-of-scale benefits; specialisation; or the development of new products, for which the concentration provides the necessary prerequisites. This is not enough by itself, however; it is part of the appraisal to examine to what extent companies could achieve efficiency benefits with less stringent measures than a concentration and to what extent the companies transfer these efficiency benefits to their customers. Juhani Jokinen, "Control of Concentrations - the New Weapon of Competition Policy" (1998), *available at* http://www.kilpailuvirasto.fi/cgi-bin/sivu.pl?s=juhanijokinen.

20 In Japan, efficiencies are examined in their impact on competition. When improvement of efficiency is deemed likely to stimulate competition, these positive impacts are considered. *See* Guidelines for Interpretation on the Stipulation that "The Effect May Be Substantially to Restrain Competition in a Particular Field of Trade" Concerning M&As (Fair Trade Commission, 21 Dec. 1998), *available at* http://www.apeccp.org.tw/doc/Japan/Decision/jpdec3.htm. Accordingly, efficiency increase is just one of the factors to be considered when determining whether a certain merger would be pro- or anti-competitive, and does not by itself render the merger more acceptable from the point of view of the Japanese merger legislation. OECD, "Competition Policy and Efficiencies Claims in Horizontal Agreements", Doc. OCDE/GD (96) 65 (Paris, 1996).

21 **Council Regulation (EC) No 139/2004 of 20 January 2004 on the control of concentrations between undertakings.**

the European Commission (**EC**) must consider in its analysis of horizontal mergers, which include "the development of technical and economic progress, provided that it is to consumers' advantage and does not form an obstacle to competition". The requirement of "no obstacle to competition" is an integral part of the general competition test articulated in Articles 2(2) and (3) of the ECMR and, in effect, acts as a safeguard by providing a limit above which a merger cannot be considered as beneficial for consumers. Arguably, this requirement may make it unlikely that a dominant firm will be able to assert efficiencies as a defence, since any improvement in efficiency may enhance its position of dominance. In such cases, efficiencies may even be treated as an offence in the sense that they add to the factors that contribute to the creation or strengthening of a dominant position.[22] This view is illustrated by the EC's actions in *Du Pont/ICI*[23] and *Shell/Montecatini*[24]*,* two transactions in which the EC required undertakings that sought to provide comparable or shared efficiency benefits for competitors before allowing the transactions to proceed. In addition, in the GE/Honeywell merger[25], the EC took the position that the merger would provide incentives for the merged entity to discount prices to customers through mixed bundling, thereby restricting the ability of rivals to compete, leading to increased marginalisation and eventually elimination of the competitors. In turn, competitor exit from the marketplace would lead ultimately to higher prices and lower quality products. The EC held that price cuts resulting from mixed bundling were not the type of real efficiency that should be taken into account in a merger analysis, but, instead, constituted a form of "strategic pricing" by the merged firm.

(b) Efficiencies as a defence

19. A merger efficiencies defence appears to be more prevalent in small open-trading economies where domestic markets may not permit a large number of firms to achieve economies of scale. Where greater concentration is needed to do so, more permissive merger efficiency regimes are observed.

20. In Canada, for example, the current law provides that a transaction that has been

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22 For example, in both Germany and Finland, economic advantages from economies of scale and scope, rationalisation and synergies have been identified as factors that can create market entry barriers and further strengthen the market position of the merged entity.

23 *Du Pont/ICI* O.J. L7/13 (1993) (Comm'n).

24 *Shell/Montecatini* O.J. L332/48 (1994) (Comm'n).

25 *General Electric/Honeywell*, Case No. COMP/M. 2220 (2001) (Comm'n).

found to prevent or lessen competition substantially can be defended by showing that the efficiencies created outweigh the anti-competitive effects of the transaction. The Canadian statutory efficiency defence[26] permits an anti-competitive merger so long as the efficiency gains that would be lost by blocking the merger are greater than and offset the anti-competitive effects of permitting the merger.[27] In practice, merging parties may raise the defence, both in the initial assessment phase before the Canadian Competition Bureau and again, if necessary, when the merger is challenged by the Canadian Commissioner before the Competition Tribunal. While the Canadian efficiency defence has been part of Canada's merger law for over 15 years, it has only been tested on one occasion: the merger of national propane companies Superior Propane Inc. and ICG Propane Inc. The lengthy litigation in the *Superior Propane* case[28] has, at least for now, confirmed that merger efficiencies are not an "intractable subject for litigation"[29] and can be measured, proved and weighed against anti-competitive effects in a real case. In that case, it was the opinion of the Tribunal that the real resource savings or efficiencies from the merger made the merger socially beneficial to the Canadian economy, despite the fact that the merger created an entity with significant market power in the propane distribution business in Canada.

21. In the UK, an "evaluative" analysis akin to an efficiency defence is undertaken where it is argued that the OFT need not refer the merger to the UK CC because efficiencies are claimed to constitute "customer benefits" that will outweigh any SLC. However, the UK OFT Merger Guidelines state that only on "rare occasions" does the OFT expect that it will be sufficiently confident of customer benefits to clear mergers that it believes are likely to result in an SLC.[30] Further, it is not sufficient to demonstrate that there are merely some theoretical benefits to customers; the merging parties

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26 §96, Canadian *Competition Act*.

27 It is important to note that the Canadian efficiency defence was enacted at the same time as Canada entered into a Free Trade Agreement with the U.S. and that Canadian businesses were perceived to be likely to have difficulty developing efficient size from scale economies to compete with large U.S. companies within Canada and abroad.

28 *Commissioner of Competition v. Superior Propane Inc., et. al* (2000), 7C.P.R. (4th) 385 (Comp. Trib); rev'd in part, *(Canada) Commissioner of Competition v. Superior Propane* (2001), 199 D.L.R. (4th) 130 (Fed. C.A.); *The Commissioner of Competition v. Superior Propane Inc. et al* (2002), 18 C.P.R. (4th) 417, (Comp. Trib.); conf'd *Commissioner of Competition v. Superior Propane Inc. et. al* (2003), 223 D.L.R. (4th) 55 (F.C.A.), *available at* http://www.ct-tc.gc.ca/english/cases/propane/propane.html.

29 Richard Posner, *Antitrust Law: An Economic Perspective* (2d. ed., 2001) at 111-112, noting that "[t]he measurement of efficiency ... [is] an intractable subject for litigation".

30 *See* UK OFT Merger Guidelines at ¶¶ 7.7 - 7.10.

must also show that the parties will have the incentive to pass benefits on to customers and that these benefits will be sufficient to outweigh the competition detriments caused by the merger.[31]

22. The UK CC may have regard to relevant customer benefits (*i.e.,* lower prices, higher quality, greater choice or greater innovation) when determining appropriate remedies to an SLC. In principle, with sufficient customer benefits, the UK CC could decide that an SLC would occur, but that no remedy whatsoever is appropriate. However, the UK CC Merger Guidelines note that, "It would not normally be expected that a merger resulting in an SLC would lead to benefits to customers". Such benefits must accrue immediately or "within a reasonable period" as a result of the merger and must be "unlikely to accrue without the creation of that situation or a similar lessening of competition". The burden of proof is on the merging parties.[32]

23. Romanian competition law[33] permits transactions: (a) that increase economic efficiency, enhance production, distribution or technical progress or increasing export competitiveness; (b) so long as the positive effects of the concentration compensate for the negative effects; and (c) to a reasonable extent, consumers benefit from the resulting gains, especially through lower real prices. Therefore, efficiency gains must offset any anti-competitive effects of the merger. However, no standard of proof concerning the claimed efficiencies has been specified.

24. It would also appear that the Irish Competition Authority considers efficiencies as a defence (at least in name) rather than as part of the total assessment of the competitive effects of a merger. However, it is clear from the Irish Guidelines that "consumer welfare" is paramount, and a finding of no SLC would occur only where consumer welfare has not been reduced.

25. While Brazil in practice has adopted an efficiency defence, many of the mergers permitted based on the alleged efficiencies have been subject to performance commitments by the merging parties.

(c) Public interest (or public benefits) test

31 Benefits that are "sufficient to outweigh the competition detriments" may result in the elimination of SLC, which would suggested that the efficiency analysis is really part of the SLC determination.

32 UK CC Merger Guidelines at ¶¶ 4.34 - 4.45.

33 Chapter III of Law No 21/1996 on Competition.

26. Under a public interest test, various aspects of the public interest are considered regarding the social suitability of a merger. "Public interest" may be defined quite broadly and can include such elements as employment effects and regional distributions of income. When the public interest test is dominated by efficiency considerations, it can resemble an efficiency defence. In other cases, efficiencies may be thrown into the "public interest soup" and it may be difficult to determine their relative significance.[34]

27. A public benefit test is used in Australia where an acquirer may decide, or may be encouraged by the ACCC, to apply for authorisation in circumstances where a transaction that may breach section 50 of the TPA is likely to deliver public benefits, which include efficiency gains.[35]

28. In Germany, it is conceivable that efficiencies may be considered as part of a public benefits test under section 42 of the *Act Against Restraints of Competition*, which permits the German Federal Minister of Economics and Labour to, in exceptional cases, authorise a merger that had been previously prohibited by the German Federal Cartel Office because of its anti-competitive effects. In these cases, the “macro-economic” advantages (*i.e.*, economy-wide) of the merger must outweigh its competitive restraints or, alternatively, the merger must be justified by a paramount interest of the public, including advantages of rationalisation.[36] However, given the few Ministerial authorisations that have been granted, it is difficult to derive any general conclusion as to whether and how efficiencies may be factored into this macro-economic analysis.

III. MERGER-SPECIFICITY

29. Firms often undertake acquisitions when their management believes it is the most profitable means of enhancing capacity or capacity utilisation, new knowledge or

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34 Ann-Britt Everett and Thomas W. Ross, "The Treatment of Efficiencies in Merger Review: An International Comparison", University of British Columbia and Delta Economics Group Inc. (22 November 2002) ("**Everett & Ross**"), *available at* http://strategis.ic.gc.ca/pics/ct/ct02516e.pdf.

35 The New Zealand regime also contains provision for the authorisation of otherwise anti-competitive mergers on public benefit grounds. However, this aspect is not covered in the NZ Practice Note.

36 The Minister has held that the advantages arising from rationalisation and synergies due to the merger must be of a significant macro-economic importance. Only such cost savings will be taken into account that exceed ordinary potentials for rationalisation. This can be the case, if the merger generates significant R&D capacities or allows the use of certain production processes that could not exist without the merger. Mestmäcker/Veelken in Immenga/Mestmäcker, 2001 at § 42, ann. 31.

skills, or entering new product or geographic arenas.[37] The decision to undertake a major acquisition typically is part of a broader plan to achieve long-term company growth and reorganisation objectives. Efficiencies may be realised in many types of business arrangements, such as mergers, joint ventures, licensing and distribution arrangements, and strategic alliances. Some of these arrangements impose greater restrictions on competition than do others. Mergers generally represent the most limiting of these arrangements as they effectively remove one competitor from the marketplace entirely. As a result, most of the jurisdictions examined (including the U.S., Canada, the EU, the UK (both the OFT and the UK CC) and Australia) have incorporated a requirement that efficiencies claims be "merger-specific".

30. In the U.S., the merger-specific requirement is significant because, instead of requiring proof that claimed efficiencies could not be achieved through some hypothetical alternatives (such as unilateral expansion or competitor collaborations), the U.S. antitrust authorities have committed to evaluate claimed efficiencies against other practical alternatives.[38] The U.S. courts have, at the urging of the enforcement agencies, been very literal in their treatment of merger-specificity and have focussed on whether a firm would likely achieve the efficiencies absent the transaction, and on blocking those transactions in which the court found that such efficiencies would occur.[39]

31. But what alternative means of achieving efficiencies should be considered? The Canadian *Merger Enforcement Guidelines* (**Canadian Merger Guidelines**) provide that only if the alternative means is a common "industry practice" will it be considered. Examples of alternatives include internal growth, enhancing capacity or capacity utilisation, a merger with an identified third party, a joint venture, a specialisation agreement, or a licensing, lease or other contractual arrangement.[40]

32. Similarly, the horizontal merger guidelines of the European Union (**EU Merger Guidelines**) state that the merging parties must provide all information necessary to

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37 Paul A. Pautler, "Evidence on Mergers and Acquisitions" (25 September 2001) (unpublished) at 1-2.

38 Robert Pitofsky, "Efficiencies in Defense of Mergers: 18 Months After" George Mason Law Review Antitrust Symposium, The Changing Face of Efficiency (Washington, 1998) at 2, available at: http://www.ftc.gov/speeches/pitofsky/pitofeff.htm.

39 Gotts & Goldman at 276.

40 Canadian Merger Guidelines at §5.2.

demonstrate that there are no less anti-competitive, realistic and attainable alternatives of a non-concentrative nature (*e.g.*, a licensing agreement, or a cooperative joint venture) or of a concentrative nature (*e.g.*, a concentrative joint venture, or a differently structured merger) than the proposed merger under which the efficiencies are claimed.[41] The EC will then consider only those alternatives that are reasonably practical in the business situation faced by the merging parties, having regard to established business practices in the industry concerned. The U.S. *Horizontal Merger Guidelines* (**US Merger Guidelines**) of the Federal Trade Commission (**FTC**) and Department of Justice impose as the test whether the efficiencies are "likely to be accomplished with the proposed merger and unlikely to be accomplished in the absence of either the proposed merger or other means having comparable anti-competitive effects".[42]

33. However, there may be a number of reasons why firms do not pursue efficiencies internally. For example, a firm may not want to expand its infrastructure to take advantage of new technological efficiencies because the industry already has excess capacity or the associated costs would be prohibitive. That firm, however, could benefit from substantial efficiencies by merging with a competitor and consolidating its operations in the competitor's operations. Further, adding new capacity in a stable or declining demand environment may place downward pressure on price, thereby making such expansion unprofitable. In addition, adding new capacity may result in social waste to the extent that duplicate resources at the acquired firm subsequently may be scrapped.[43] More importantly, most merger efficiencies cannot reasonably be achieved by the merging firms on their own; there may be good reasons why, absent the merger, the merging firms would not co-operate in ways to achieve the efficiency.

IV. TYPES OF EFFICIENCIES CONSIDERED

34. Not all types of efficiencies are treated equally under the law (or, for that matter, by economists). Currently, there appears to be a trend towards accepting only those

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41 *Commission Notice on the Appraisal of Horizontal Mergers under the Council Regulation on the Control of Concentrations Between Undertakings* (28 January 2004) at ¶ 85.

42 See US Merger Guidelines at §4, available at: http://www.usdoj.gov/atr/public/guidelines/horiz_book/hmg1.html.

43 William J. Kolasky, "The Role of Efficiencies in Merger Review" (2001) 16 *Antitrust* 82-87.

variable production cost savings that can be achieved in a relatively short time frame, whereas other fixed cost savings or riskier or longer term efficiencies will be ignored or discounted. Pecuniary efficiencies (*i.e.*, efficiencies that result in a mere redistribution of income from one person to another) are also not generally accepted. Under the US Merger Guidelines, some types of efficiencies are recognised as more likely than others to meet the relevant criteria.

35. Further, certain types of cost savings may be accorded greater weight than others owing to issues of the difficulty of evidentiary proof or establishing merger-specificity. For example, the US Merger Guidelines place "procurement, management and capital cost savings" in the category of efficiencies that "are less likely to be merger-specific or substantial, or may not be cognisable for other reasons". In other words, these types of efficiencies are given little weight due to the reasons stated above.

(a) Fixed cost savings

36. Generally speaking, cost efficiencies that lead to reductions in variable or marginal costs are more cognisable to competition authorities than reductions in fixed costs because they are more likely to result in lower consumer prices and to be achieved in the short term. In other words, efficiencies are thought to be more cognisable where they impact upon variable costs (and thus marginal cost), since such cost savings tend to stimulate competition and are more likely to be passed directly on to consumers in the form of lower prices (because of their importance in short-run price setting behaviour).[44]

37. However, David Painter, formerly of the U.S. FTC, believes that, contrary to most common perceptions, reductions in fixed costs *can* lead to lower prices to consumers, as well as other significant non-price benefits. In his presentation on merger efficiencies before the FTC[45], he cited two separate studies[46] in support of his

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44 UK OFT Merger Guidelines at 27.

45 David T. Painter and Gabriel H. Dagen, "Panel 4 - How and in What Context Do Cost Savings of Various Kinds Affect Business Decision Making? What Have Been the FTC and DOJ's Experience with Efficiency Claims?" Federal Trade Commission, A Roundtable Sponsored by the Bureau of Economics Understanding Mergers: Strategy & Planning, Implementation and Outcomes (9-10 December 2002, Washington, D.C.) ("**Painter & Dagen**"), *available at* http://www.ftc.gov/be/rt/xscriptpanel4.pdf.

46 V. Govindarajan and R. N. Anthony. "How firms use cost data in pricing decisions" Management Accounting (July 1983) ("**Govindarajan & Anthony**"); E. Shim and E. F. Sudit, "How Manufacturers Price Products" Management Accounting (February 1995).

primary argument that, in reality, fixed costs are taken into account far more often than not in setting prices.[47] In support of his argument, Painter sets out several examples of both price and non-price benefits that can arise from fixed cost savings.

38. Further, determination of what costs might be "variable" in any given instance is highly problematic and can be a matter of the analysis timeframe adopted: reductions in fixed costs can eventually become variable in the long run and therefore can play an important role in longer term price formation.[48]

39. Finally, as Donald McFetridge points out, if savings in fixed costs are to be ignored or discounted, then several real savings, including economies of density, economies derived from rationalisation (such as the elimination of set-up or change-over costs) and efficiencies in R&D, marketing and capacity expansion, could be ruled out.[49]

(b) Pecuniary or redistributive efficiencies

40. In general, pecuniary efficiencies (*i.e.*, efficiencies that result in a mere redistribution of income from one person to another) will not be considered in a merger/efficiency analysis.[50] For instance, under Canadian law, efficiency gains that are brought about "by reason only of a redistribution of income between two or more persons" will not be considered in the trade-off analysis between efficiencies and anti-competitive effects.[51] The reasoning behind this principle is that all gains realized pursuant to a merger do not necessarily represent a saving in resources. For example, gains resulting from increased bargaining leverage that enable the merged entity to extract wage concessions or discounts from suppliers that are not cost-justified represent a mere redistribution of income to the merged entity from employees or the supplier; such gains are not necessarily brought about by a saving in resources.[52]

41. Miguel de la Mano of the EC suggests that a general way to predict whether

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47 Govindarajan & Anthony, cited in Painter & Dagen at 237. For example, the two studies showed that approximately 40% percent of large manufacturing companies set prices by marking up some version of full costs, *i.e.*, a combination of fixed and variable costs.

48 Firms naturally consider the merger process as a long-run phenomenon in which all costs would be considered variable. Competition authorities, on the other hand, treat mergers as a short-run phenomenon creating obvious conflicting conclusions regarding the ultimate effects of a merger on the industry and the economy.

49 Donald G. McFetridge, "Efficiencies Standards: Take Your Pick" (2002) 21:1 Can. Comp. Rec. 45 ("**McFetridge**") at 54, *available at* http://www.carleton.ca/~dmcfet/courses/efficiencies.PDF.

50 However, it should be noted that the US Merger Guidelines do not expressly discount pecuniary efficiencies.

51 *Competition Act*, §96(3).

52 Canadian Merger Guidelines at §5.3.

efficiency claims relating to purchasing operations are real efficiencies is to evaluate the degree of competition in both sides of the input market. In a competitive input market, with many suppliers and buyers, verifiable economies of scale and scope in procurement are likely to correspond to real cost savings.[53]

42. Some may view the hostility towards procurement savings as unfortunate, as procurement savings consistently generate the bulk of near-term savings in mergers - increased volume typically results in lower unit costs and the combination of best practices in sourcing approaches.[54] Yet most jurisdictions do not acknowledge them as the types of efficiency gains that should be considered.[55]

(c) Productive efficiencies

43. Productive efficiencies are perhaps the least controversial category of efficiencies - they are readily quantifiable, often associated with variable costs, and, for the most part, broadly accepted by economists and competition authorities alike. Productive efficiency is optimised when goods are produced at minimum possible cost, and includes: (1) economies of scale (*i.e.*, when the combined unit volume allows a firm to operate at a lower unit cost); (2) economies of scope (*i.e.*, when the joint use of an asset results in a lower overall cost than firms had when they operated independently); and (3) synergies.

44. Production efficiencies leading to economies of scale can arise at the product-level, plant-level and multi-plant-level and can be related to both operating and fixed costs, as well as savings associated with integrating new activities within the combined firms.

45. Examples of plant-level economies of scale include:[56]

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53 Miguel de la Mano, "For the customer's sake: The competitive effects of efficiencies in Europe Merger Control", Enterprise Papers No. 11 (2002) ("**de la Mano**") at 65, *available at* http://europa.eu.int/comm/enterprise/library/enterprise-papers/pdf/enterprise_paper_11_2002.pdf.

54 "Procurement savings are particularly persuasive where the reduction in the number of buyers or the streamlining of the buying process will reduce the costs of the suppliers and these reduced costs will be passed on to consumers in the short term." David Balto, "The Efficiency Defense in Merger Review: Progress or Stagnation?" (Fall 2001) *Antitrust* at 77.

55 Both Canada and Ireland expressly exclude procurement savings unless they represent real cost savings. However, in Australia, pecuniary benefits such as lower input prices due to enhanced bargaining power may be relevant in a §50 context.

56 Gotts & Goldman at 278-279.

- specialisation, *i.e.*, the cost savings that may be realised from shifting output from one plant with a high marginal cost of production to another lower-cost plant, without changing the firms' production possibilities frontier[57];
- elimination of duplication;
- reduced downtime;
- smaller inventory requirements;
- the avoidance of capital expenditures that would otherwise be required.
- consolidation of production at an individual facility; and
- mechanisation of specific production functions previously carried out manually.

46. Multi-plant-level economies of scale can arise from:[58]

- plant specialisation;
- rationalization of administrative and management functions (*e.g.*, sales, marketing, accounting, purchasing, finance, production) and the rationalization of R&D activities; and
- the transfer of superior production techniques and know-how from one of the merging parties to the other.

47. Economies of scope occur when the cost of producing or distributing products separately at a given level of output is reduced by producing or distributing them together. Sources of economics of scope include:[59]

- common raw inputs;
- complementary technical knowledge; and
- the reduction or elimination of distribution channels and sales forces.

48. Synergies are the marginal cost savings or quality improvements arising from any source other than the realisation of economies of scale. Examples include:[60]

- the close integration of hard-to-trade assets;
- improved interoperability between complementary products;

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57 de la Mano at 62.

58 Gotts & Goldman at 278.

59 *Id*. at 280.

60 For a comprehensive review of the role of synergies in merger review, *see* Joseph Farrell and Carl Shapiro, "Scale Economies and Synergies in Horizontal Merger Analysis" (2001) 68 Antitr. L.J. at 685-710.

- the sharing of complementary skills; and
- the acquisition of intangible assets, such as brand names, customer relationships, hard-to-duplicate human capital, functional capabilities (marketing, technological and operational) and “best practices.”

49. As the summary table to this chapter illustrates, most of the jurisdictions examined will consider, in varying degrees, many of these categories of productive efficiencies.

(d) Distribution and promotional efficiencies

50. The Canadian Merger Guidelines expressly acknowledge the acceptance of efficiencies relating to distribution and advertising activities and the EU Merger Guidelines recognise cost savings in distribution functions. In the U.S., a 1995 FTC Global Staff Report viewed promotional efficiencies as "less likely to be substantial and often likely to be difficult to assess".[61] FTC Chairman Muris, however, has stated that "in the cost structure of consumer goods, promotion plays an important role, particularly since the larger market share may be needed to achieve minimum efficient scale".[62]

(e) Dynamic or innovative efficiencies

51. While productive efficiencies are achieved from producing goods at lower cost or of enhanced quality using existing technology, innovative efficiencies are benefits from new products, or product enhancement gains achieved from the innovation, development or diffusion of new technology. However, while R&D efficiencies offer great potential because they tend to focus on future products, there may be formidable problems of proof.[63] Innovation efficiencies may also make a significant contribution to competitive dynamics, the national R&D effort and consumer (and overall) welfare.

52. As a general proposition, society benefits from conduct that encourages innovation to lower costs and develops new and improved products. The EU, the UK (OFT and CC), Ireland, Canada, Brazil and Japan all appear to recognise these types of

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61 In 1995, the FTC held Global Competitive Hearings on, *inter alia*, the role of efficiencies in M&A antitrust review. The resulting report endorsed integrating further efficiencies into the competitive effects analysis. “**FTC Roundtable**” at 33).

62 J. Howard Beales and Timothy J. Muris, *State and Federal Regulation of National Advertising* (AEI Press, Washington, D.C., 1993) at 7-10.

63 Gotts & Goldman at 282.

efficiencies. While R&D efficiencies may be considered in the U.S., they are "generally less susceptible to verification and may be the result of anti-competitive output reductions."[64]

(f) Transactional efficiencies

53. An acquisition can foster transactional efficiency by eliminating the "middle man" and reducing transaction costs associated with matters such as contracting for inputs, distribution and services.[65] In general, market participants design their business practices, contracts and internal organisation to minimise transaction costs and reduce exposure to opportunistic behaviour (*e.g.*, hold-ups). Joint ventures and common ownership can help align firms' incentives and discourage shirking, free riding and opportunistic behaviour that can be very costly and difficult to police using arm's-length transactions.[66] Therefore, some commentators think that transactional efficiencies should be recognised as real benefits from a merger.

54. Among the jurisdictions reviewed, the UK CC[67], Canada, Brazil and Ireland appear to recognise the benefit of transactional efficiencies.[68]

(g) Demand-side network effects

55. Network effects occur when the customer's value of a product increases with the number of people using that same product or a complementary product. For instance in communications networks, such as telephones or the Internet, the value of the product increases with the number of people that the user can communicate with.[69]

56. Each of the UK (OFT and CC), Ireland and Brazil expressly acknowledge demand-side network effects.

(h) Managerial cost savings

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64 US Merger Guidelines, § 4.

65 However, not all transactional costs involve third parties. For example, transactional could include internal management time and the cost of "opportunistic hold-up", which are unlikely to involve significant third-party costs. Further, internal transaction costs are very different from the "management cost savings" discussed later.

66 Gotts & Goldman at 284.

67 UK CC Merger Guidelines at ¶4.44, with respect to vertical integration.

68 In this respect, it should be emphasised that the EU Merger Guidelines address horizontal mergers and not non-horizontal (vertical/conglomerate) mergers. It is in the latter context that transactional cost savings are more likely to play a role. Also, the US Merger Guidelines are primarily concerned with horizontal mergers.

69 de la Mano at 69.

57. In general, competition authorities will discount managerial efficiencies because they are not merger-specific and they represent fixed cost reductions less likely to be passed on to consumers in the short term. Managerial efficiencies arise from the substitution of less able managers with more successful ones. However, managerial skill and imagination often may be difficult to measure, abundantly available through contract, or even unpersuasive as a factor that positively affects competitive dynamics. In practice, managerial efficiencies are disfavoured by competition authorities because of the difficulties in establishing that the acquired firm cannot improve its efficiency in ways that are less harmful to competition.[70]

58. The financial literature recognises the disciplining effect of the "market for corporate control" (*i.e.*, M&A) as a means of weeding out bad management and moving assets to their highest-valued uses.[71] In large public corporations particularly, a failure of management to maximise the profits of the corporation may be a result of internal inefficiency (sometimes referred to as "x-inefficiency"). It is the recoupment of some of these inefficiencies that motivates some transactions, particularly hostile ones. If managerial efficiencies are ignored and certain take-overs are made more difficult, competition policy may reduce the disciplining role of the take-over threat and the transfer of unique, or at the very least, scarce know-how brought to the merger by new management.

59. In a November 2002 speech to the American Bar Association, FTC Commissioner Leary recognised that "innovation or managerial efficiencies . . . are probably the most significant variable in determining whether companies succeed or fail . . . Yet, we do not overtly take them into account when deciding merger cases . . . We tend to ignore the less tangible economies in the formal decision process because we simply do not know how to weigh them."[72] Indeed, there are no reported instances in which any of the competition authorities studied expressly recognised managerial efficiencies in the merger review and permitted the transaction to proceed on that basis.

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70 *Id*. at 68.

71 Gotts & Goldman at 286.

72 Thomas B. Leary, "Efficiencies and Antitrust: A Story of Ongoing Evolution" ABA Section of Antitrust Law 2002 Fall Forum, Washington, D.C. (8 November 2002) ("**Leary**"), *available at* http://www.ftc.gov/speeches/leary/efficienciesandantitrust.htm.

60. Nor is the EU entirely receptive to this category of savings. In *Aerospatiale-Alenia/de Havilland*, for instance, the management cost savings identified by the parties were rejected as not being merger-specific: "These cost savings would not arise as a consequence of the concentration *per se*, but are cost savings which could be achieved by de Havilland's existing owner or by any other potential acquirer."[73]

61. In a different light, perhaps the authorities are doing the right thing in ignoring/discounting managerial efficiencies. Indeed, there clearly is merit in having a merger enforcement policy where the competition authority can be held accountable for its actions. Otherwise, it would become a matter of total discretion.

(i) Capital cost savings

62. While capital-raising efficiencies are one of the most persistent advantages of corporate size, savings in capital costs are unlikely, on their own, to be of such significance to offset the price increases induced by increased market power.[74] Moreover, as capital markets are in the Chicago school of thought generally assumed as efficient, there is in an SLC framework no persuasive reason to recognise capital-raising savings as efficiencies, absent a strong showing that the merger would address identifiable capital market imperfections. On the other hand, superior access to the capital markets is in many jurisdictions regarded as one important factor which gives rise to market power.

63. The decision of the EC in the GE/Honeywell case provides an example of how capital cost savings were treated as a factor which gave rise to a dominant market position.[75]

64. As with productive scale economies, some may argue that these savings should also

73 *Aerospatiale-Alenia/de Havilland*, O.J.L 334/42 (1991) (Comm'n) at ¶ 65.

74 de la Mano at 66.

75 In assessing the potential competitive harm of the merger arising from the proposed bundling, the EC identified what was referred to as GE's "market dominance tool kit", which included GE's financing arm, GE Capital. In the EC's view, GE Capital provided GE with significant financial advantages which would allow GE to take more risk in product development than its competitors and (at least initially) to heavily discount the sale of its engines. Its competitors, on the other hand, did not have access to internal financing and would have to rely on external sources. The EC was also concerned that GE would be able to pass on its access to lower-cost financing (from its AAA bond rating) to Honeywell. Arguably, the combination of these two financial tools would provide the merged entity with a unique advantage that could not be otherwise duplicated by Honeywell's competitors. The EC believed that these advantages would provide incentives for GE/Honeywell to discount prices through mixed bundling, causing a restriction in competition, increased competitor marginalisation and, eventually, competitor exit. This, in turn, would lead to higher prices and lower quality products. See Gotz and Drauz, "European Union Law: Unbundling GE/Honeywell: The Assessment of Conglomerate Merger Under EC Competition Law" (2002) 25 Fordham Int'l L.J. 885 at 897-903.

be recognised because they can dramatically improve a firm's cost position, and ultimately, its competitiveness in the marketplace - to the extent that these cost savings are likely to be passed on to consumers only over the long-term (and a consumer welfare standard is deployed), the value of these savings can be discounted appropriately.[76]

V. STANDARDS FOR WEIGHING EFFICIENCIES AGAINST ANTI-COMPETITIVE EFFECTS

65. The debate continues regarding the legitimate goals of antitrust. Even in the U.S. and Canada, with over one hundred years of "modern" antitrust legislation, it is not possible to definitively state the goals of the law. In the area of merger efficiencies, a key issue is what standard should be applied in determining which beneficial effects and which anti-competitive effects are to be considered. For example, should a merged firm's efficiencies be necessarily "passed on" to consumers in the form of price reductions or other benefits (as required in a "consumer welfare" model), or should the benefits to society as a whole arising from the efficiencies be the determining factor (as promoted in "total welfare" models)? This question is ultimately informed by the goal of the relevant antitrust law. In any event, it is useful to understand the merits and limitations of the full range of standards – regardless of the goal of a particular jurisdiction's antitrust law. The standards reviewed, in order of decreasing strictness, are as follows:

(a) price standard;

(b) consumer surplus standard;

(c) Hillsdown consumer surplus standard;

(d) balancing weights approach; and

(e) total surplus standard.

(a) Price standard

66. Under the price standard, proven efficiencies must prevent price increases in order to reverse any potential harm to consumers. Efficiencies are considered as a positive factor in merger review, but only to the extent that at least some of the cost-savings are passed on to consumers in the form of lower (or not higher) prices. The

76 Gotts & Goldman at 289.

emphasis here is on the immediate price-related benefits to the consumer.

67. While the price standard has been attributed by some to the U.S. antitrust authorities, the more appropriate view (which is supported by the U.S. DOJ and FTC) is that there is no basis in the US Merger Guidelines for suggesting that U.S. agencies ignore benefits to consumers that are not in the form of price reductions.

(b) Consumer surplus standard

68. The "consumer surplus standard", which assesses the effects of a merger on consumer welfare, appears to have at least two different interpretations. One interpretation (which has been taken by the U.S. and the EU) views the consumer surplus standard as a refined version of the price standard under which a merger will be permitted to proceed if there is no net reduction in consumer surplus. While it is a given that consumer surplus will increase if efficiencies cause prices to fall *ceteris paribus*, consumer surplus can still increase if prices rise, so long as consumers benefit in other ways, as from the introduction of new products, better quality or better service. These other consumer benefits translate into a shifting outward of the demand curve, in which case, consumers will remain better off due to, say, the product improvements made possible by the merger, even though prices may rise.[77]

69. Many of the jurisdictions examined (including the U.S.[78], the EU, Finland, the UK[79] and Ireland) appear to have adopted this interpretation of consumer surplus standard.

70. The price standard and a consumer surplus standard that requires benefits to be passed on to consumers raise difficulties where the principal "consumers" are in fact large corporations that purchase, for example, significant quantities of commodity

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77 In the reverse scenario, a merger may result in the reduction in the number of brands produced. In this case, the merger might still pass a price test (because prices do not rise) but fail the consumer surplus standard (because the reduced quality lowers total consumer welfare). *See* Everett & Ross at 21.

78 While most commentators have interpreted the US Merger Guidelines as adopting the price standard or consumer surplus standard, Bill Kolasky and Andrew Dick point out that the Guidelines do not fully embrace a form of consumer surplus standard but, rather, provide that consideration will be given to the effects of cognisable efficiencies with no-short term, direct effect on prices. They characterise the U.S. approach as a "hybrid consumer welfare/total welfare model", under which efficiencies that benefit consumers immediately will receive the most weight, while other efficiencies, to the extent that they can be proved and shown to ultimately benefit consumers, will also be considered. William J. Kolasky and Andrew R. Dick, "The Merger Guidelines and the Integration of Efficiencies into Antitrust Review of Horizontal Mergers" (2003) 71 Antitr. L.J. 207 at 230, *available at* http://www.usdoj.gov/atr/hmerger/11254.pdf.

79 Under the UK OFT Merger Guidelines, the claimed customer benefits must accrue to customers of the merging parties (or to customers in a chain beginning with those customers), but need not necessarily arise in the market(s) where the SLC concerns have arisen. It is therefore conceivable that sufficient customer benefits might accrue in one market as a result of the merger that would outweigh a finding of SLC in another market(s). To show that benefits in one market outweigh an expected SLC in another will require clear and compelling evidence. UK OFT Merger Guidelines at ¶7.9.

goods such as oil, potash or propane. In this regard, the beneficiaries of the efficiencies will be the shareholders of the large corporations, who may be in a no less favourable position than the shareholders of the merged entity. This problem is exacerbated when the "consumers" are primarily foreign-owned firms, in which case the benefits of the efficiencies arising from a purely domestic merger would be "exported" to the foreign shareholders.

(c) Hillsdown Consumer Surplus Standard

71. The second interpretation of the consumer surplus standard (which is also referred to as the Hillsdown standard[80] and appears to be the interpretation given in Canada) permits a loss in consumer surplus, provided that the efficiency gains resulting from the merger exceed this loss. Under this standard, the post-merger efficiencies must exceed the sum of the dead-weight loss plus the loss to consumer surplus (which is transferred to producers). The transfer of wealth from consumers to producers is considered only as an adverse effect in the balancing equation; no corresponding gain to producer surplus is acknowledged.

72. Some observers believe that the Hillsdown standard is not consistent with any known economic welfare theory: by ignoring the transfer of wealth to producers, the standard in effect disregards the maximisation of social welfare and does not distinguish between the "transfer of wealth and the destruction of wealth"[81], *i.e.*, that gains to producers (and their shareholders) can be socially positive.

73. The Hillsdown standard assigns the same weight to all consumers, therefore protecting *all* consumers, even when some consumers may be better off than sellers and their shareholders. The reality is, since many firms are in fact owned by consumers (either directly or through shareholdings by pension plans, for example), profit increases can accrue to the ultimate benefit of consumers. This issue then becomes whether all consumers count or just those covered by the relevant antitrust market definition.

74. The Hillsdown standard was eventually argued by the Canadian Commissioner in *Superior Propane* in the rehearing before the Canadian Competition Tribunal as the

80 The Hillsdown standard is derived from the *obiter dictum* in the Canadian *Hillsdown* decision: *Canada (Director of Investigation and Research) v. Hillsdown Holdings (Canada) Ltd.* (1992), 41 C.P.R. (3d) 289 (Comp. Trib.).

81 McFetridge at 55.

correct standard, but ultimately rejected by the Tribunal as being inconsistent with the policy goal of promoting efficiency.

(d) Total surplus standard

75. Total surplus is the sum of consumer and producer surplus. If the result of a merger is to raise the price of the relevant product without improving quality, consumer surplus decreases; if the merger is profitable, producer surplus increases through excess profits. Some of the increase in producer surplus arises from the decrease in consumer surplus. This is the so-called "transfer" of wealth or welfare. Under the total surplus standard, the anti-competitive effect of the merger is measured solely by the dead-weight loss to society (that is, the loss of producer and consumer surplus resulting from the price increase). This means that efficiencies merely need exceed the dead-weight loss to permit an otherwise anti-competitive merger to proceed.

76. Unlike the Hillsdown standard, which assigns a zero value to the wealth transferred from consumers to producers, the total surplus standard assigns an equal weight to both the loss in consumer surplus and the corresponding gain to producer surplus. In other words, the transfer of wealth is viewed as "neutral" [82] The rationale for a total surplus standard is grounded in the oft-criticised belief that the wealth transfer effects of mergers are neutral due to the difficulty of assigning weights to certain effects *a priori* based on who is more deserving of a dollar.[83]

77. In New Zealand, the NZCC recently reiterated that the proper test in that country is the total surplus standard. In its July 2003 paper setting out the analytical framework for a pending investigation into allegations of monopolistic price-gouging

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82 Professor Townley is critical of the neutrality assumption in the total surplus standard. He argues that, if it is not possible to conclude that the parties affected by a merger value "dollars" differently, then it is not possible to conclude that they value them equally. Therefore, there is no basis for concluding that the transfer of wealth is neutral or is not neutral. "Efficiency Standards: They also serve who only sit and weigh(t)" (2003) 21(2) Can. Comp. Rec. 115 ("**Townley**") at 119.

See also Professors Ross and Winter, who argue that the fact that all individuals in the economy consume, and therefore can be labelled consumers, does not in itself mean that a transfer from one group of individuals to another can be treated as neutral. Rather, a transfer is "welfare-improving" if it transfers wealth from more wealthy to less wealthy individuals. *A priori*, it cannot be said that consumers in a particular market are of the same wealth as shareholders. (For example, in some markets – ski resorts, airline, private jets, spa services, luxury goods in general – consumers are relatively wealthy; whereas in other markets, consumers may be less wealthy than shareholders.) Moreover, to the extent that a large fraction of companies are owned by, say, union and teacher pension plans, it is quite possible that price increases divert wealth from relatively more wealthy consumers to relatively poorer consumers. Thomas W. Ross and Ralph A. Winter, "The Efficiency Defense in Merger Law: Economic Foundations and Recent Canadian Developments", presented at the Competition Law Roundtable, University of Toronto (13 December 2002) ("**Ross & Winter**") at 37.

83 Canadian Merger Guidelines, § 5.5.

by the owners of New Zealand's natural gas pipeline networks, the NZCC considered that, under the *Commerce Act 1986*, any decision to regulate pipeline prices would have to be justified by reference to "a net public benefit test, as distinct from a net acquirers' benefit test":

> "In summary, a net public benefit analysis considers net total welfare effects. Under this analysis, any deadweight efficiency loss due to allocatively inefficient prices would count as a net public detriment, but any transfer of wealth from consumers to suppliers (or vice versa) would not." [84]

78. Some have suggested that the relevant standard for authorisations in Australia is the total surplus standard.[85] Professor Corones concludes that, "as long as the claimed public benefit involves a reduction in social costs, it does not matter that the cost saving is not passed on to consumers in form of lower prices; however, it would be necessary to have regard to how widely the cost saving is shared among the group of beneficiaries."[86] In *Queensland Co-operative Mining Association Ltd,*[87] the Australian Tribunal indicated that private benefits (*e.g.,* to the shareholders of merging firms) could be considered as public benefits. Further, in the *7-Eleven Stores* case, the Tribunal stated that "the assessment of efficiency and progress must be from the perspective of society as a whole: the best use of society's resources."[88] In 2002, the ACCC denied an application for authorisation of the proposed merger of Australian Pharmaceutical Industries Ltd. with Sigma Company Ltd.[89] Whilst the ACCC accepted that the merger would achieve efficiency gains, it found that any efficiency gains would be likely to be retained by the merger entity for its benefit and the benefit of its shareholders.

79. However, Professor Hazeldine of the University of Auckland suggests that the Australian public benefits test differs from the New Zealand test in that greater consideration will be given to efficiencies that are passed on to consumers.[90] This

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84 NZCC, Gas Control Inquiry: Draft Framework Paper (16 July 2003) at 14, ¶1.

85 Everett & Ross at 40.

86 Stephen G. Corones, *Competition Law in Australia*, 2nd ed. (LBC Information Services, 1999).

87 *Re Queensland Co-operative Mining Assn Ltd* (1976) ATPR 40-012.

88 *Re 7-Eleven Stores Pty Ltd* (1994) ATPR 41-357.

89 Application for Authorisation: A30215, "Australian Pharmaceutical Industries Ltd. In respect of proposed merger with Sigma Company Ltd" (11 September 2003) (ACCC).

90 Tim Hazledine, "Pie in the Sky? The Proposed Cartel between Qantas and Air New Zealand", Prepared for presentation to the 14th Annual Workshop Competition Law & Policy Institute of NZ (Auckland, 23-24 August 2003).

can be seen in the ACCC's recent Final Determination in relation to the proposed acquisition of Air New Zealand by Qantas Airways and further cooperative arrangements among Qantas, Air New Zealand and Air Pacific.[91] In reviewing the public benefits claimed by Qantas and Air New Zealand, the ACCC stated at paragraph 13.65 (p.146):

> "Finally, it should again be noted that the cost saving benefits accrue to the Applicants and their shareholders. While the Commission is of the view that benefits to a particular group or segment of the community may be regarded as benefits to the public, consideration needs to be given as to whether the community has an interest in that group being benefited and whether that benefit is at the expense of others – for example, consumers through higher prices. The level of competition in a market will affect both the durability of the benefit and the likelihood and extent of that benefit being passed through to consumers. Where benefits are not passed on to consumers this may be symptomatic of a lack of competitive pressure that would otherwise cause such benefits to endure and be passed through. Such benefits are likely to be accorded a lower weight by the Commission."[92]

80. Prior to the Canadian *Superior Propane* case, the total surplus standard had been the proper test in Canada since the early 1990s and had been written into the Canadian Merger Guidelines. In *Superior Propane*, the Canadian Commissioner ignored the fact that the total surplus standard had been endorsed in his very own Canadian Merger Guidelines and took the initial (and contrary) view that the standard was too easy a test to meet and should therefore be abandoned. However, some Canadian critics suggest that, had the total surplus standard been properly argued by the Commissioner by taking into account pre-merger market power[93] and the loss of

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91 Applications for Authorisation: A30220, A30221, A30222, A90862 and A90863, "Acquisition by Qantas Airways Limited of ordinary shares in Air New Zealand Limited and cooperative arrangements between Qantas, Air New Zealand and Air Pacific Limited" (9 September 2003) (ACCC).

92 In an appendix to the Final Determination, the ACCC addressed the anti-competitive detriment analysis of the airlines' economic consultants, Network Economic Consulting Group (NECG) at page C-17:

> "Finally, NECG's analysis did not fully address the issue of the distribution of the estimated benefits and detriments of the alliance between various parties, other than making some adjustments for international wealth transfers. The Commission analysed the burden of anti-competitive detriments and possible detriments to examine the distributional effects implicit within the NECG Model. This analysis shows that in aggregate, while deadweight losses reduce both consumers and producers surplus, Qantas and Air NZ benefit through significant welfare transfers from Australian, New Zealand and foreign consumers. The net effect on the Applicants is strongly positive, but for consumers is unambiguously negative. In gross terms, the transfer payments from consumers to producers are far in excess of the deadweight loss estimates provided by NECG. Furthermore, the NECG modelling fails to quantify the extent to which the benefits to Qantas accrue to foreign shareholders, rather than to Australia."

93 Margaret Sanderson states as follows: "Mergers in markets with pre-existing market power can still give rise to a substantial lessening of competition. Further, the greater the amount of pre-existing market power, the greater the efficiencies must be in order to offset the resulting welfare loss. As a consequence, the more closely a merger approaches a merger to monopoly, the less likely it is that any efficiency accompanying the merger will offset the

producer surplus[94], the merger in *Superior Propane* may not have been permitted under this standard.[95]

81. While favoured by many economists, it would appear, however, that from a political viewpoint most competition authorities are reluctant to adopt the total surplus standard.[96]

82. Putting aside welfare arguments for the time being, perhaps the strongest argument for the adoption of the total surplus standard arises in the need to stimulate and make efficient emerging economies or the new economies of developing nations. In this regard, factors to consider include the nature of the particular economy in question, the degree to which it is integrated with the economies of other trading nations, its historical economic experience with competition and competition law, the extent of regulation and deregulation, and its relative size. Indeed, the focus for developing countries seeking to participate in the global marketplace will be on creating an internationally competitive and efficient economy. In these circumstances, the relevant competition authorities may want to consider a more flexible if not responsive approach to efficiencies.[97]

(e) Balancing weights approach

83. The balancing weights approach attempts to find a balance between the redistributive effects or transfer of wealth from consumers to producers/shareholders by assessing the relative adverse effects on those "more deserving or less well-off" consumers. In

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resulting welfare loss. The total surplus standard does not need to be abandoned to achieve this result. It only needs to be properly applied as articulated in the Merger Enforcement Guidelines." Margaret Sanderson, "Competition Tribunal's Redetermination Decision in *Superior Propane*: Continued Lessons of the Value of the Total Surplus Standard" (2002) 21:1 Can. Comp. Rec. 1-5.

94 In a market in which market power is already being exercised pre-merger, there will be a loss of both producer and consumer surplus from a price increase. This is highly likely in most cases where efficiencies will matter (that is in highly concentrated markets). This has two implications. The first is that the post-merger firm may have no incentive to raise price further as it will lose a portion of the producer surplus. Second, and more relevant to efficiencies, one must count both the producer surplus loss and the consumer surplus loss against the efficiency gains. The producer surplus loss is a real loss to the economy and could be significant. In the *Superior Propane* case, the Canadian Competition Tribunal was not presented with evidence of producer surplus and therefore considered only the consumer surplus loss, which was small in relation to the expected cost savings.

95 *See* Frank Mathewson and Ralph Winter, "The Analysis of Efficiencies in Superior Propane: Correct Criterion Incorrectly Applied" (2000) 20 Can. Comp. Rec. 2, *available at:* http://www.chass.utoronto.ca/~rwinter/papers/efficienc.pdf.

96 For example, FTC Commissioner Leary does "not believe this is a fruitful policy debate, for the simple reason that no endorsement of an overall welfare standard is politically viable in [the U.S.]; The assumption that sellers are already much richer than buyers is just too deeply entrenched, even though it obviously is not always true." *See* Leary.

97 See generally, Michal Gal, "Competition Policy in Small Economies", OECD Global Forum on Competition (7 February 2003), *available at:* http://www.olis.oecd.org/olis/2003doc.nsf/0/aba73de0eefbb274c1256cc60041ea19/$FILE/JT00138914.PDF.

other words, the redistributive effects will be considered if those who "lose" from the merger are less well-off than those who gain from the merger. When comparing the adverse effects to the magnitude of the efficiency gains, it must be determined whether the adverse effects are so egregious that a premium should be attributed to those adversely-affected consumers relative to the producers/shareholders.[98]

84. The balancing weights approach was first introduced in Canada in the *Superior Propane* case by the Canadian Commissioner's expert witness, Professor Peter Townley[99], endorsed by the Canadian Federal Court of Appeal, later abandoned by the Commissioner in favour of the Hillsdown standard, and subsequently applied (at least in principle) by the Canadian Competition Tribunal. It remains the current law in Canada. Brazil also, to a certain degree, employs a form of balancing weights approach. The difficulty in this approach, of course, is determining the relative degree of harm to those consumers to be protected when compared to the producer/shareholder gains from the efficiencies.

85. The above assessment requires a socio-economic value judgement that depends on case-specific evidence and the deciding body's perception of the marginal social utilities of income (or wealth) of the consumers and producers/shareholders affected by the merger.

86. While the balancing weights approach may be considered as a reasonable compromise between the consumer surplus standard and the total surplus standard, it is considered by some as largely unworkable because of this value judgement.[100] Whereas, the burden to show the nature and extent of the anti-competitive effects of a merger is typically placed on the government, which is uniquely placed to obtain and quantify this type of information, it may be beyond the competence and ability of

98 Townley at 118. It should be noted that the above description of the balancing weights approach attirbutes to the decision-makers a degree of precision and knowledge that may be overstated. In practical terms, the balancing weights approach is simply a pragmatic method to guide the decision-makers. If the merger passes the total surplus standard, the natural result is that the resource savings from efficiencies are greater than the dead-weight loss. Therefore, the former divided by the latter must be greater than one. (In *Superior Propane*, it was approximately 1.6.) The competition authority must then decide whether other considerations - such as distributional or equity factors - should be factored into the particular situation. If such a need exists, then the authority must decide whether these factors, in their totality, command such a premium that it is worth giving up the net efficiency gains.

99 Peter G. C. Townley, "Report, Exhibit A", Expert affidavit submitted in *Commissioner of Competition* v. *Superior Propane Inc. and ICG Propane Inc.* (August 1999), *available at* http://www.ct-tc.gc.ca/english/cases/propane/115.pdf.

100 However, Townley observes that all other standards also require value judgements. For example, he states that, "total surplus accords equal distributional weights and the price standard gives winners zero (or losers infinite) relative weight, both regardless of the actual circumstances of a particular merger. Consumer surplus lies between these extremes...". Townley at 126.

merging parties (and the reviewing agency) to obtain and assess the socio-economic evidence of the affected customers. Accordingly, without clear guidelines, merger review may become a lengthy and uncertain process under the balancing weights approach. Perhaps over time, a paradigm for this approach could be developed and proxies could be used to make these decisions; however, because of the high level of uncertainty involved, merging parties would not have a clear rule to guide them in merger planning for years to come.

VI. STANDARD AND BURDEN OF PROOF TO SUBSTANTIATE EFFICIENCIES

87. The expected value of an efficiency is a function of both the magnitude and the likelihood of the efficiency. Part of the suspicion and scepticism surrounding efficiencies arises from the difficulties in gauging future events with precision.[101]

88. The credibility of efficiencies claims depends on verification of the claims and the strength of the evidence overall. Efficiencies may be substantiated by the following types of evidence:[102]

- a company's internal plans and cost studies, as well as public statements;
- engineering and financial evaluations;
- industry studies from third-party consultants;
- economics and engineering literature;
- testimony from industry, accounting and economic experts;
- information regarding past merger experience in the industry; and
- information on firm performance from the stock market.

89. While it is true that forecasting synergies from a merger is an uncertain and difficult exercise, this may be no more speculative than forecasting the potential for SLC or the competitive response of rivals or poised entrants to possible price increases by the merged entity.[103] The more experience with efficiencies, the more likely that the

101 Gotts & Goldman at 261.

102 *Id.* at 263-265.

103 However, in cases with concentration levels similar to those found in the U.S. *Heinz* case, or in matters where unilateral effects are predicted, there is a well-established paradigm for predicting competitive effects. In such cases, there may well be less confidence and experience in judging what types of mergers are likely to fail to obtain expected efficiencies.

appropriate paradigm will emerge for incorporating them into the analysis.[104] However, efficiencies will always need a case by case assessment.

90. The problem of verification must also be considered in view of the empirical evidence that suggests that many mergers fail to deliver their projected efficiencies. Therefore, the following questions need to be answered when evaluating claimed efficiencies: (1) is the decision to merge based on projected efficiencies (or only motivated by market power)? and (2) are the efficiency estimates held by the firms reasonable (taking into account the history of failure)?[105]

VII. SHOULD EFFICIENCIES PERMIT MERGERS WITH LARGE MARKET SHARES?

91. Debate remains regarding to what extent efficiencies should be considered in mergers resulting in large market concentrations. One approach that has been used on occasion in the U.S. is to take into account the post-merger market concentrations. Under this approach, the lower the concentration levels, the more likely competition authorities will factor into the analysis the efficiencies' benefits of a transaction. For transactions raising higher concentration concerns, this approach "discounts" efficiency claims. Moreover, as indicated in the US Merger Guidelines and in recent U.S. court decisions, it is very unlikely that efficiencies will ever outweigh large anti-competitive effects.[106]

92. Similarly, the use of structural market share indicators appears to correspond to the current EU model, which uses a relatively high threshold for its structural presumptions. The EU Merger Guidelines also provide that it is unlikely that a market position approaching that of a monopoly can be declared compatible with the common market on efficiency grounds.[107]

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104 It is to be noted that at one time U.S. practitioners retained economic experts to calculate HHI ratios.

105 Lars-Hendrick Röller, Johan Stenneck and Frank Verboven, "Efficiency Gains from Mergers" (2000) The Research Institute of Industrial Economics, Working Paper No. 543 at 60.

106 In the U.S. baby food case of *Heinz*, while the D.C. Circuit Court exhibited scepticism and hostility to efficiencies due to the concentration levels that would exist post-merger, it did leave open the possibility that, at least in some cases, an efficiencies defence could succeed. The Court held that the high market concentration levels present in *Heinz* required, in rebuttal, proof of "extraordinary" efficiencies. *FTC v. H.J. Heinz Co.*, 116 F. Supp. 2d 190 (D.D.C. 2000); rev'd, 246 F.3d 708 (D.C. Cir. 2001).

107 EU Merger Guidelines at ¶ 84.

93. The Canadian efficiency defence provides no limits to the level of concentration that can be authorised thereunder. As a matter of law, the Canadian Competition Tribunal is not permitted to block a merger solely based on market share. Without such limits, the acceptance of a valid efficiency defence theoretically may permit the creation of a monopoly or near monopoly.[108]

94. While the Australian Merger Guidelines do not expressly state that gains in efficiency can justify or offset the elimination or near elimination of competition, it has been suggested that the ACCC may be open to the possibility.[109] In a recent speech, former Australian Commissioner Jones reported that:

> "... in granting authorisation the Commission is giving immunity from a significant economic principle. It is allowing firms to substantially lessen competition, and thereby gain substantial market power, even monopoly power."[110]

95. In Brazil, merger filings that would result in both possible anti-competitive effects and high market shares were allowed to proceed based on the alleged efficiencies. However, due to the lack of specific standards (and a more developed antitrust experience) for the analysis of efficiencies, Brazilian authorities have been generally discretionary in these cases.

96. It is argued that it may be better to discard the presumption based on concentration in favour of a case-by-case adjudication of other factors such as market conditions and net efficiencies.[111] This argument is based on the opinions of some scholars who view the presumption on concentration levels as weak (absent extraordinary circumstances of creation or enhancement of unilateral market power).[112] However, while the existing theories for attacking mergers on concentration and market share grounds alone may lack a firm empirical foundation, competition authorities appear to be reluctant (and perhaps justifiably so) to permit mergers that result in inordinately

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108 However, monopoly, in practice, is at best an elusive concept. Instead, it is perhaps more appropriate to speak of "market power" or "high market shares". Accordingly, because of the offsetting resource savings to the Canadian economy resulting from the merger in *Superior Propane*, the practical effect of the Canadian Competition Tribunal's decision was to allow a merger that gave the merging parties the ability to raise prices and exercise market power.

109 Everett & Ross at 43.

110 Commissioner Ross Jones, "The Rationale for Merger Laws" Speech delivered at The Thirteenth Annual Workshop of The Competition Law and Policy Institute of New Zealand (2 August 2002) at 17. Ross Jones retired from the ACCC on 30 June 2003.

111 Gotts & Goldman at 268.

112 *Id*. at 269.

high market shares.[113]

VIII. SIGNS OF REFORM

97. In the UK, the treatment of efficiencies has been clarified in the recently promulgated *Enterprise Act*. Previously the "public interest" test could take account of efficiencies, but the CC inquiry teams were not bound as to what issues they considered to be relevant to their conclusions. The new sets of UK CC and OFT Guidelines make the assessment of efficiencies much more explicit.

98. In the U.S., adverse court decisions have led some antitrust lawyers to advise their clients not to make the effort necessary to put forward their best efficiencies case.[114] Recognising this problem, FTC Chairman Muris has stated that, "internally we take substantial well-documented efficiencies arguments seriously. And we recognise that mergers can lead to a variety of efficiencies beyond reductions in variable costs." Moreover, Chairman Muris indicated that efficiencies can be important in cases that result in consent decrees, and in the formulation of remedies that preserve competition while allowing the parties to achieve most, if not all, efficiencies. He has reassured antitrust counsel that well-presented credible efficiencies will be given due consideration by the FTC in merger review.

99. In Europe, critics have argued that a merger policy that does not take into account efficiency gains (including cost savings that are passed on to consumers in the form of lower prices) may be harmful to European competitiveness, especially in high-tech industries. Accordingly, the EC recently indicated that it is examining its views on efficiencies and may view efficiencies more favourably in the future. In July 2002, EC Commissioner Monti stated, "We are not against mergers that create more efficient firms. Such mergers tend to benefit consumers, even if competitors might suffer from increased competition."[115] He (1) expressed support for an efficiencies

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113 Some jurisdictions respond to this concern by making concentration or market share only one element of the analysis, which must be considered only in tandem with other factors such as barriers to entry. From a competition authority's point of view, this "reluctance" is perfectly justified, as it depends on what levels of market share and concentration may arise.

114 Timothy J. Muris, "Understanding Mergers: Strategy and Planning, Implementation, and Outcomes" FTC Roundtable at 2, *available at* http://www.ftc.gov/speeches/muris/mergers021209.htm.

115 Mario Monti, "The Future for Competition Policy in the European Union" Address at Merchant Taylor's Hall, (London, 9 July 2001), *available at:* http://europa.eu.int/rapid/start/cgi/guesten.ksh?p_action.gettxt=gt&doc=SPEECH/01/340|0|RAPID&lg=EN

defence; (2) noted that reform will be accompanied by the issuance of interpretative market power guidelines to assist in providing market definition and how efficiency considerations should be taken into account; and (3) indicated that the EU will not stop mergers simply because they reduce cost and allow the combined firm to offer lower prices, thereby reducing or eliminating competition. Commissioner Monti concluded, however, that "it is appropriate to maintain a touch of 'healthy scepticism' with regard to efficiency claims, particularly in relation to transactions which appear to present competition problems."[116]

100. The recently issued EU Merger Guidelines similarly indicate that:

> "The Commission considers any substantiated efficiency claim in the overall assessment of the merger. It may decide that, as a consequence of the efficiencies that the merger brings about, there are no grounds for declaring the merger incompatible with the common market pursuant to Article 2(3) of the Merger Regulation. This will be the case when the Commission is in a position to conclude on the basis of sufficient evidence that the efficiencies generated by the merger are likely to enhance the ability and incentive of the merged entity to act pro-competitively for the benefit of consumers, thereby counteracting the adverse effects on competition which the merger might otherwise have."[117]

101. In Canada, the former Canadian Commissioner of Competition viewed the outcome of *Superior Propane* as an unacceptable result. At the time, however, he chose not to launch a further appeal, but rather, sought legislative reform by supporting draft amendments to the Canadian *Competition Act* put forth in a private member's bill (Bill C-249[118]). Bill C-249, which has gone through accelerated passage in Canadian Parliament with very little opportunity for public consultation, seeks to repeal the statutory efficiency defence in its entirety and, purportedly, to bring Canadian law in line with the treatment of efficiencies in other jurisdictions such as the U.S. and the EU. Under the draft legislation, a merger will no longer be assessed by looking at the "trade-off" between the post-merger efficiencies and the anti-competitive effects of

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116 Mario Monti, "Review of the EC Merger Regulation – Roadmap for the Reform Project Conference on Reforms of European Merger Control" British Chamber of Commerce (Brussels, 4 June 2002) at ¶ 31, *available at*: http://europa.eu.int/rapid/start/cgi/guesten.ksh?p_action.getfile=gf&doc=SPEECH/02/252|0|AGED&lg=EN&type=PDF.

117 EU Merger Guidelines at ¶ 77. The Guidelines further require that "efficiencies should be substantial and timely, and should, in principle, benefit consumers in those relevant markets where it is otherwise likely that competition concerns would occur". EU Merger Guidelines at ¶79.

118 *Bill C-249, An Act to amend the Competition Act*, 2nd Sess., 37th Parl., 2002, *available at* http://www.parl.gc.ca/PDF/37/2/parlbus/chambus/house/bills/private/c-249_3.pdf.

the merger. Rather, post-merger efficiencies will be considered (in some unspecified fashion) as part of the overall SLC assessment of the merger, with regard to whether such efficiencies will be "passed on" as benefits to consumers in the form of, for example, lower prices or improved product choices.

102. In its current form, the draft legislation raises several uncertainties, including as to (a) how exactly efficiencies will be assessed when compared to other factors considered in the government's competitive analysis of a merger; (b) whether this legislation adopts a price standard or a form of consumer surplus standard; (c) which consumers would be eligible to receive the benefits of the efficiency gains; (d) how merging parties would demonstrate that the passing-on of efficiencies to consumers would sufficiently mitigate any anti-competitive effects of the merger; and (e) how such a passing-on requirement would, in practice, be enforced. What can be expected, however, if Bill C-249 were to be enacted as drafted, efficiencies will have minimal significance in all but a limited number of cases, and efficiencies alone will almost never "trump" a merger to monopoly.[119]

103. At this time, the future of this Bill C-249 is unknown. While the bill has passed second reading in the Canadian Senate, it received a considerable "dressing down" by members of the Canadian competition bar and Professor Peter Townley when they appeared before the Senate Standing Committee on Trade, Banking and Commerce reviewing the bill in November 2003. Following this hearing, the Standing Committee issued a letter to the Minister of Industry, recommending that Bill C-249 should be subject to a wider public consultation process, similar to those used for other proposed amendments to the *Competition Act*. Further, with the recent departure of former Commissioner von Finckenstein and the appointment of a new Commissioner[120], it remains to be seen whether Bill C-249 will be resurrected in its current form.

104. In Australia, the Dawson Committee concluded in its report to the Australian

119 Many in the Canadian business and legal community believe that the balancing weights approach advocated in the *Superior Propane* case properly reflects the intention of the Canadian government in its objectives of promoting a more cost-effective and internationally-competitive economy for a small open trading economy like Canada: the fact that gains in efficiencies which are real and specific to a merger may override certain anti-competitive effects is consistent with this broader national objective.

120 On 12 January 2004, the Canadian Government appointed Sheridan Scott, Chief Regulatory Officer of Bell Canada, as its new Commissioner of Competition. Her experience includes nine years at the Canadian Radio-television and Telecommunications Commission where she was involved in major telecommunications and broadcasting hearings.

government[121] that the introduction of an efficiency test would produce a more complex clearance process, requiring more time and the exercise of greater discretion by the ACCC. The Committee therefore concluded that efficiencies should be considered, where necessary, as part of the total authorisation procedure. It further stated that the existing public benefits test for merger authorisations is broad enough to encompass any factors relevant to efficiency. The Government of Australia has accepted the Committee's recommendations in this area.

IX. CONCLUSION

105. If indeed there is a need for the adoption and evolution of a broader and more universally consistent treatment of merger efficiency claims, competition authorities will be required to increasingly develop an expertise in evaluating efficiencies and their effects, including: (1) determining what efficiencies should be included in a trade-off against post-merger anti-competitive effects, including a consideration of fixed costs and less certain long-term savings; (2) how such efficiencies should be quantified; and (3) once quantified, how they should be weighed against any losses to consumers or other anti-competitive effects.

106. The authors suggest that the next step in the process may be the consideration of first principles, including perhaps the following:

1 There should be the creation of a standard template to categorise the types of efficiencies to be adduced by merging parties – in this regard, the most permissive interpretations from the various jurisdictions noted above will be instructive.

2 Each jurisdiction would then be permitted to consider and accept or reject any part or all of the above categories put forward. Each jurisdiction would be required to identify which factors it will not consider in an open and transparent way.

3 No jurisdiction would apply efficiencies to count against a merger.

4 There would be no presumption of illegality based on post-merger market

121 "The Dawson Committee Report on the *Trade Practices Act*" (23 April 2003).

concentrations alone. Rather, the merger would be examined in light of all factors, including the efficiencies provided thereby and the barriers to entry.

5 The requirement for merger-specificity should not be based on speculative or theoretical possibilities for achieving the efficiencies absent the merger.

6 Competition authorities should provide guidance on how efficiencies will be identified and measured in a merger submission and how the evidentiary burden is to be discharged. This should be coupled with guidance on the weight that will be given to efficiencies if they are proven to the reasonable satisfaction of the competition authority in the overall assessment of the merger.

7 Competition authorities should attempt to develop an actual standard to be used in weighing efficiencies, as well as the degree, if any, to which the efficiencies may outweigh any anti-competitive effects of a merger. In such cases, there may be a need for an empirically-tested model.

107. It should be noted that it is difficult to formulate properly any kind of recommendation for best practices based on the entire foregoing “conceptual framework”, particularly in the absence of empirical support. However, we have articulated the above draft first principles more as “discussion points” rather than as a firm foundation for the development of "best practices" in the analysis of merger efficiencies.

Issue	United States	Canada	Brazil
Governing law	• Clayton Act • US Merger Guidelines • *Heinz* case	• *Competition Act* • Canadian Enforcement Guidelines • *Superior Propane* case	Administrative Council of Economic Defense - Administrative Rule n. 15/98
Treatment of efficiencies	Considered as part of total SLC assessment	Efficiency defence	Efficiency defence
Types of efficiencies claims considered*	• Rationalisation and multi-plant economies of scale are more cognisable • R&D – less cognisable • Procurement, management or capital cost – least cognisable	• Production (including economies of scale and scope and synergies) • Transactional • R&D • Dynamic • Distribution and advertising	• Economies of scale • Economies of scope • Transaction cost reduction • The introduction of more productive technology • Positive externalities or elimination of negative externalities • The generating of compensatory market power
Must efficiencies be merger-specific?	Yes	Yes	Yes
Standard for weighing efficiencies	Consumer surplus — However, the effects of cognisable efficiencies with no short-term, direct effect on prices will be also considered.	Balancing weights approach	Consumer surplus Balancing weights approach
Efficiencies must be passed on to consumers?	Yes - over time	No	Efficiencies must be passed to consumers, but there is no authority on the methodology to be used.
Standard of proof to claim efficiencies	• Efficiencies must be "cognisable", i.e., merger-specific, verifiable and cannot arise from anti-competitive reductions in output or service. • "Extraordinary" cognisable efficiencies required where potential adverse competitive effects are likely to be particularly large.	Parties must show, on the balance of probabilities, that a merger is likely to bring about gains in efficiencies that will be greater than and will offset the effects of SLC and that efficiencies would not be achieved if the order sought were made.	Efficiencies can not be vaguely established or speculative, and must be capable of being reasonably monitored.
Relationship between	Efficiency gains must show that transaction is not likely to be anti-	Efficiency gains must be "greater than and offset" the anti-competitive effects.	Efficiencies must be "greater than and offset" the anti-competitive effects.

* This list may not necessarily be exhaustive. Please refer to the applicable guidelines for further information.

Issue	United States	Canada	Brazil
efficiencies and anti-competitive effects	competitive.		
High market shares permitted?	Yes, but efficiencies almost never justify a merger to monopoly or near-monopoly.	Yes, efficiencies may trump a merger to monopoly or near-monopoly.	Yes
Suggested reform	Increased willingness to accept evidence of efficiencies.	Draft legislation may replace the efficiencies defence by a consideration of efficiencies that are likely to benefit consumers as part of the SLC test.	None at this time

Issue	EU	UK	Ireland
Governing Law	• ECMR • EU Merger Guidelines	• *Enterprise Act 2002* • UK OFT Merger Guidelines • UK CC Merger Guidelines	*Competition Act 2002*
Treatment of efficiencies	Efficiencies have to benefit consumers, be merger-specific and be verifiable. (EU Merger Guidelines, ¶78).	**UK OFT:** • Normally, efficiencies must avert an SLC by increasing rivalry within the market. • In its duty to refer mergers to the UK CC, the UK OFT will consider efficiencies that do not avert an SLC but will nonetheless be passed on after the merger in the form of customer benefits. **UK CC:** • Normally, efficiencies must avert an SLC by increasing rivalry within the market. • In deciding remedies for an SLC, may have regard to relevant customer benefits that are sufficient to remove the need for a remedy to the SLC.	Efficiencies defence

Issue	EU	UK	Ireland
Types of efficiencies permitted*	• Should benefit consumers in those relevant markets where it is otherwise likely that competition concerns would occur. (EU Merger Guidelines, ¶79) • Cost savings in production or distribution (EU Merger Guidelines, ¶80) • New or improved products or services from R&D and innovation (EU Merger Guidelines, ¶81)	**UK OFT:** • Cost savings (fixed or variable) • More intensive use of existing capacity • Economies of scale or scope • Demand side efficiencies such as increased network size or product quality • Reductions in fixed costs are also given weight • Capturing of complementarities in R&D activity which might increase incentives to invest in product development in innovation markets • Can be in another market. **UK CC:** No explicit or exhaustive list for efficiencies to be taken account when assessing whether an SLC has occurred.	• Efficiencies that are likely to Increase price rivalry, including savings relating to more efficient purchasing processes, efficiencies arising from network effects in demand, efficiencies due to technology transfer and demand-side efficiencies **EXCLUDED:** • Savings due to the integration of administrative functions • Input price reductions related to buyer power • Efficiencies related to economies of scale that do not involve marginal cost reductions • Efficiencies that reduce prices in one market but do not compensate for increases in another
Merger specificity?	Yes	**UK OFT:** Yes **UK CC:** Yes	Yes
Standard for weighing efficiencies	Consumer surplus	**UK OFT:** Customer surplus for cases that are not referred to the UK CC. **UK CC:** Customer surplus for determining remedies.	Consumer surplus
Efficiencies passed onto consumers?	• Consumers cannot be worse of as a result of the merger (EU Merger Guidelines ¶79). • Efficiencies should be substantial and timely (EU Merger Guidelines ¶79).	**UK OFT:** For cases not referred to the UK CC, efficiencies must be passed on as benefits to customers. **UK CC:** In determining remedies, the only relevant customer benefits that will be considered by the UK CC are lower prices, higher quality, greater choice or greater innovation (¶4.37 of the UK CC Merger Guidelines).	Overall effect result in lower net prices for consumers

*** This list may not necessarily be exhaustive. Please refer to the applicable guidelines for further information.**

Issue	EU	UK	Ireland
Standard of proof to claim efficiencies	Efficiencies have to be verifiable such that the EC can be reasonably certain that the efficiencies are likely to materialise, and be substantial enough to counteract a merger's potential harm to consumers. (EU Merger Guidelines ¶86)	**UK OFT:** Efficiencies that are claimed to enhance rivalry must be: • demonstrable; • merger-specific; and • likely to be passed on to customers. Rare for efficiencies to outweigh SLC. **UK CC:** • SLC - If efficiency gains are to argued as increasing rivalry among the remaining firms in the market, the UK CC will need to form an expectation that the claimed efficiencies: – will result within a short period of time; and – result as a direct consequence of the merger. • Remedies - Rare for a merger resulting in an SLC to lead to customer benefits. Burden of proof is on merging parties claiming relevant customer benefits in the context of remedies to an SLC.	• Parties must demonstrate that there is a sufficient likelihood that efficiencies will be realised. • Must show that efficiencies cannot be achieved in another way that is less restrictive to competition and will be achieved within a reasonable timeframe and with sufficient likelihood. • Must be clearly verifiable, quantifiable and timely.
Relationship between efficiencies and anti-competitive effects	Efficiency gains cannot form an obstacle to competition.	**UK OFT and UK CC:** • Normally, efficiencies will be permitted only where they increase rivalry in the market, *i.e.,* no SLC. • Efficiencies passed on as benefits to customers may mitigate anti-competitive effects in rare cases.	• Efficiencies must be sufficient to outweigh both any increase in price-cost margins and any uncertainties about their realisation. • No finding of SLC provided that consumer welfare is not reduced.
High market shares permitted?	Highly unlikely that a merger leading to a market position approaching that of a monopoly (or leading to a similar level of market power) can be declared compatible with the common market on the ground that efficiency gains would be sufficient to counteract its potential anti-competitive effects. (EU Merger	**UK OFT:** Unlikely – enough competition must remain to ensure pass on to consumers of a "reasonable share" of benefits. **UK CC:** UK CC Merger Guidelines do not discuss the point.	Not specified but unlikely.

Issue	**EU**	**UK**	**Ireland**
	Guidelines, ¶84).		
Suggested reform	New EU Merger Guidelines released in early 2004.	*Enterprise Act*, UK CC Merger Guidelines and OFT Guidelines came into force on June 20, 2003.	None

Issue	**Germany**	**Finland**	**Romania**
Governing law	*Act Against Restraints of Competition* (**ARC**) **NOTE:** While §42 of the ARC could theoretically encompass efficiencies as a benefit to be considered in the context of a Ministerial authorisation, the paucity of such authorisations does not allow any general conclusion or rules to be made. Therefore, reference to the consideration of efficiencies under §42 is more speculative than authoritative.	*The Act on Competition Restrictions* 480/1992 (Chapter 3a)	Chapter III of Law No 21/1996 on Competition
Treatment of efficiencies	• Public benefits test (§42 ARC)	As part of the "creation or strengthening of a dominant position" analysis	Efficiencies defence
Types of efficiencies permitted*	Not restricted to a particular market (§36 ARC), but no precedent established to date.	Not specified, but may include: • Synergy • Economies of scale benefits • Specialisation • Development of new products	Not specified
Merger specificity?	Possibly, in the context of §42 Ministerial authorisation.	Yes	Not specified
Standard for weighing efficiencies	No precedent established to date.	Consumer surplus	Not specified
Efficiencies passed onto	No precedent established to date.	Yes, customers or consumers	Not specified

*** This list may not necessarily be exhaustive. Please refer to the applicable guidelines for further information.**

Issue	Germany	Finland	Romania
consumers?			
Standard of proof to claim efficiencies	• Public benefits must be "concretely verifiable" (§42 ARC).	Not specified	Not specified
Relationship between efficiencies and anti-competitive effects	• Efficiencies may form part of the benefit to the public interest: the total benefit must outweigh the competition restraints (§42 ARC)	Efficiencies must offset any anti-competitive effects of the merger.	Efficiencies must offset any anti-competitive effects of the merger.
High market shares permitted?	• Under §42 ARC, high market shares may be justified if they are offset by substantial public benefits.	Unlikely	Not specified
Suggested reform	None	None	None

Issue	Australia	New Zealand	Japan
Governing law	• *Trade Practices Act 1974* (TPA) • Australian Merger Guidelines	• *Commerce Act 1986* • NZ Practice Note	*Act Concerning Prohibition of Private Monopolization and Maintenance of Fair Trade*
Treatment of efficiencies	• Public benefits test for authorisations • SLC review in informal clearances under §50	Unclear - public benefits or perhaps efficiency defence	Efficiencies are examined in their impact on competition
Types of efficiencies permitted*	• Economies of scale • Efficiencies that allow the merged entity to become a new competitive constraint on the unilateral conduct of other firms in the market. • Pecuniary benefits such as lower input prices due to enhanced bargaining power may also be relevant in a §50 context.	The NZ Practice Note refers only to decreased unit cost of production as a permissible efficiency.	• Economies of scale • Integration of production facilities • Specialisation of factories • Reduction in transportation costs • Efficiency in R&D • Other improvements of efficiency caused by the M&A
Merger	Yes	Yes	Not specified

*** This list may not necessarily be exhaustive. Please refer to the applicable guidelines for further information.**

Issue	Australia	New Zealand	Japan
specificity?			
Standard for weighing efficiencies	• Consumer surplus for informal clearance and breach of §50 of the TPA • Unclear for authorisations	Total surplus	Not specified
Efficiencies passed on to consumers?	• Yes, for informal clearance • No, for authorisations	No	Not specified
Standard of proof to claim efficiencies	• Efficiencies must be substantiated to ascertain their magnitude and must be probable. • "Strong and credible" evidence.	• Efficiencies must be of "the required magnitude and credibility". • Parties must make a "sound and credible case" that the efficiencies will be realised, that they cannot be realised without the acquisition, and that they will enhance competition in the relevant market.	Unclear, somewhere between beyond a reasonable doubt and the preponderance of evidence.
Relationship between efficiencies and anti-competitive effects	Efficiencies must enhance competition in the market.	Efficiencies must enhance competition in the market.	Efficiencies are only considered when improvement is deemed likely to stimulate competition.
High market shares permitted?	Possibly	Not specified	Not specified
Suggested reform	Recommendations of the Dawson Committee to consider efficiencies as part of the authorisation process.	None	None

Postscript to ICN Chapter on Efficiencies

Australian Developments

Since the writing of the efficiencies chapter, there have been two significant developments in Australia concerning the consideration of efficiencies in merger matters.

The first significant development is that, on 11 November 2003, the ACCC announced that, for the first time, it would publish reasons for its consideration of mergers. This will no doubt lead to greater transparency in the ACCC's decision-making process. Three decisions have so far been published on the ACCC's web site.[122]

The publishing of such decisions should give some insight in the future into the ACCC's reasoning in its application s 50 of the TPA. One decision already published, the ACCC's assessment of Coca-Cola Amatil Limited's proposed acquisition of Berri Limited, does suggest that the ACCC considers efficiency issues to be important in assessing conduct which may contravene s 50 of the TPA. In this decision, the ACCC determined that it would oppose the proposed merger on the basis that it would have the effect, or would be likely to have the effect of substantially lessening competition in contravention of s 50. Among other concerns, the ACCC noted that, while efficiencies could be increased and costs reduced on the part of the merged firm, this would lead to a rise in rivals' costs and the efficiency gains would be unlikely to be passed on to consumers. This suggests that, contrary to the indications of Professor Corones (see paragraph 77 of the efficiencies chapter), the ACCC considers that the relevant standard in assessing efficiency in merger decisions is not the total surplus standard, as the retention of efficiency gains by the merged entity and/or its shareholders would not be a sufficient 'public interest'.

The second significant development has been the decision of the Federal Court of Australia in *Australian Gas Light Company Ltd v Australian Competition and Consumer Commission (No 3)* [2003] FCA 1525 (Unreported, French J, 19 December 2003), where a declaration was sought that a proposed merger would not contravene s 50 of the TPA. Such declaration was granted by the Court, subject to certain undertakings being given by the merged entity. This case is the first where such a declaration as to s 50 of the TPA has been sought from the Court. While the decision does not consider efficiency as a sole and determinative factor, it was still alluded to in the competition analysis conducted by French J. Given the speed at which the Court reached its decision subsequent to a trial heard in December 2003, this decision may encourage more parties contemplating mergers to seek similar declarations from the Court if the ACCC indicates that it will oppose a merger. This may lead to more detailed judicial consideration of the assessment of efficiencies in merger transactions in Australia in the future.

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[122] **As at 31 March 2004, the ACCC has made available the reasons for its decisions relating to mergers concerning (i) MiTek Australia Ltd and Austrim Nylex Limited; (ii) Coca-Cola Amatil Ltd and Berri Ltd; and (iii) (in relation to undertakings, rather than the merger itself) Perkins Shipping Pty Ltd and Gulf Freight Services Pty Ltd. The decisions can currently be found on the ACCC's web site at http://www.accc.gov.au/content/index.phtml/itemId/486967.**

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Bob Baxt, Melissa Randall and Andrew North, 5 April 2004