Office of Fair Trading

Mergers

Substantive assessment guidance

ENTERPRISE ACT 2002

The Enterprise Act 2002 received Royal Assent in November 2002. It will come into force in June 2003.

The Act makes a number of significant reforms to competition law and consumer law enforcement in the UK. The new provisions will work alongside the Competition Act 1998 and various pieces of consumer legislation, largely replacing the Fair Trading Act 1973.

The Act establishes the Office of Fair Trading (the OFT), replacing the former statutory office of the Director General of Fair Trading. The OFT will apply and enforce the new competition and consumer measures alongside the Competition Commission, the sectoral regulators, the Competition Appeal Tribunal, Trading Standards Departments and others.

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1 Purpose and scope of this guidance

1.1 This guidance is published pursuant to section 106 (1) of the Enterprise Act 2002 (the Act) to provide guidance to companies and their advisers on the criteria applied by the Office of Fair Trading (the OFT) when considering whether to refer a merger to the Competition Commission (CC) for further investigation. Subject to certain limited exceptions, the OFT has a duty to refer a merger to the CC for investigation if it believes:

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

1.2 This guidance explains both what is meant by a 'relevant merger situation' and the OFT's interpretation of the 'substantial lessening of competition' test. This guidance:

- describes the circumstances in which the OFT has jurisdiction over mergers affecting competition in the UK (chapter 2)
- explains the concept of a substantial lessening of competition (chapter 3)
- explains the principles for assessing the competitive effects of horizontal (chapter 4), vertical (chapter 5) and conglomerate mergers (chapter 6)
- addresses the circumstances in which the OFT might exercise its discretion not to refer a merger to the CC for investigation (chapter 7)
- describes the principles behind the OFT's consideration of undertakings offered in lieu of reference (chapter 8)
- explains the application of the mergers provisions of the Act to regulated industries (chapter 9) and the operation of the public interest and special merger situation provisions (chapter 10)
- describes the regime for assessment of ancillary restrictions (chapter 11)
- explains the Act's interaction with the European Community Merger Regulation (chapter 12), and

- gives contact details for the OFT's Mergers Branch and sources of additional information (chapter 13).

1.3 Information on procedural aspects of the UK merger control system, including guidance on the content of submissions to the OFT, is included in *Mergers – procedural guidance* (OFT526), published on 21 May 2003.

1.4 This guidance represents the policy and practice of the OFT at the present time, reflecting current legal and economic thinking. As this evolves, revised guidance may be considered appropriate to reflect such developments. Further information on the OFT's merger analysis may also be found in the published merger advices and decisions on the OFT's website (www.oft.gov.uk), including advices published under the Fair Trading Act 1973 merger provisions.

Institutional structure

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

1.6 **The OFT** is a new corporate body established by the Act on 1 April 2003 to carry out certain functions on behalf of the Crown. Under the Act, the OFT has a function to obtain and review information relating to merger situations, and a duty to refer to the CC for further investigation any relevant merger situations where it believes that it is or may be the case that the merger may or may be expected to result in a substantial lessening of competition. The OFT must also advise the Secretary of State on any mergers which might fall within the scope of the public interest or the special public interest provisions of the Act.[1] If a reference is made, the OFT has a duty to provide any information in its possession to the CC as the CC may require to discharge its functions. In anticipated or completed mergers, the OFT can, either on its own account, or, in public interest cases where so requested by the Secretary of State, negotiate undertakings in lieu of a reference to the CC. If asked to do so, the OFT may also advise the parties to an agreement whether restrictions therein are ancillary to a

[1] These are covered in chapter 10.

merger and hence excluded from the prohibitions in the Competition Act 1998. Outside the provisions of the Act, the OFT can provide informal advice or confidential guidance to the parties involved in mergers in contemplation which are not yet in the public domain. The OFT employs administrative, legal, economic and accounting staff to perform these functions and duties. The activities of the OFT in relation to mergers are coordinated by its Mergers Branch, part of the Competition Enforcement Division.

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

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

Contact with the OFT

1.9 Both anticipated and completed mergers are covered by the legislation. Most cases considered by the OFT are still at the proposal stage. Although UK merger control law does not require that a qualifying merger be notified, generally companies seek legal

certainty by informing the OFT about a prospective merger in advance. There is always a risk that, if a reference is made after completion, the merged businesses might have to be separated should the CC find that the merger's operation has resulted or may be expected to result in a substantial lessening of competition.

1.10 Contact details for the OFT's Mergers Branch are provided in chapter 13 of the guidance. Companies and their advisers are encouraged to contact the OFT early in the merger process to discuss the application of the Act to a merger situation.

2 What is a relevant merger situation?

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

2.2 As a general rule, mergers that fall under the scope of the European Community Merger Regulation (EC Merger Regulation) are excluded from review under the Act. (Further information on the interaction of EC merger control laws and the Act is provided in chapter 12.)

Introduction

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

- two or more enterprises (broadly speaking, business activities of any kind) must cease to be distinct, or there must be arrangements in progress or in contemplation which will lead to enterprises ceasing to be distinct
- either the merger must not yet have taken place or have taken place not more than four months before the reference is made, unless the merger took place without having been made public and without the OFT being informed of it (in which case the four month period starts from the announcement or the time the OFT is told), and
- either:
  - the UK turnover associated with the enterprise which is being acquired exceeds £70 million (known as 'the turnover test'), or
  - the enterprises which cease to be distinct supply or acquire goods or services of any description and, as a result of the merger, together supply or acquire at least 25 per cent of all those particular goods or services of that kind supplied in the UK or in a substantial part of it. To qualify, the merger must result in

an increment to the share of supply or consumption and the resulting share must be at least 25 per cent. In practice therefore, the share of supply test can only be met where the enterprises concerned supply or acquire goods or services of a similar kind. (This test is hereafter referred to as 'the share of supply test'.[2])

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

2.4 It is implicit in these criteria that at least one of the enterprises must be active within the UK. Where the turnover test is met, this will by definition be because the target generates turnover from sales to UK customers. For the share of supply test, both of the enterprises ceasing to be distinct must be active in supplying or acquiring goods or services within the UK or a substantial part of the UK. These principles apply equally to non-UK companies that sell to (or acquire from) UK customers or suppliers. In assessing whether a firm is active in the UK, the OFT will have regard to whether its sales are made directly or indirectly (via agents or traders) and the extent to which a firm is active at each level of trade.

2.5 In making a reference to the CC, the OFT (or the Secretary of State in public interest cases) need only have a reasonable belief that it is or may be the case that a relevant merger situation exists or may be expected to exist. The OFT interprets this provision to mean that a reference is possible if, on the basis of the evidence available to it, there is at least a significant prospect that a relevant merger situation exists or may be expected to exist. It is for the CC to determine in the course of its investigation whether the referred transaction amounts to a merger situation under the Act. This is of course important in cases where the merger is 'in contemplation'. The OFT will generally consider a merger to be 'in contemplation' where a public announcement has been made by the parties concerned.

Enterprises ceasing to be distinct

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

Enterprises

2.7 The term 'enterprise' is defined in the Act as the activities, or part of the activities, of a business. This does not mean that the enterprise in question need be a separate legal entity: it simply means that the activities in question should be carried out for gain or reward. However, there is no requirement that the transferred activities generate a profit or dividend for shareholders: indeed, the transferred activities may be loss making or conducted on a not for profit basis.

2.8 An 'enterprise' may comprise any number of components, most commonly including the assets and records needed to carry on the business, together with the benefit of existing contracts and/or goodwill. The transfer of 'customer records' is likely to be important in assessing whether an enterprise has been transferred. In some cases, the transfer of physical assets alone may be sufficient to constitute an enterprise: for example, where the facilities or site transferred enables a particular business activity to be continued. Intangible assets such as intellectual property rights are unlikely, on their own, to constitute an 'enterprise' unless it is possible to identify turnover directly related to the transferred intangible assets that will also transfer to the buyer.

Control

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

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

2.10 Assessment of material influence requires a case by case analysis of the entire relationship between the acquiring entity and the target. In

making this assessment, the OFT will have regard to all the circumstances of the case. The variety of commercial arrangements entered into by firms makes it difficult to state categorically what will (or will not) constitute material influence. However, the following matters are of particular relevance, although this list is by no means exhaustive.

- A shareholding conferring on the holder 25 per cent or more of the voting rights in a company generally enables the holder to block special resolutions; consequently, a 25 per cent share of voting rights is likely to be seen as presumptively conferring the ability materially to influence policy – even when all the remaining shares are held by only one person. The OFT may examine any case where there is a shareholding of 15 per cent or more in order to see whether the holder might be able materially to influence the company's policy. Occasionally, a holding of less than 15 per cent might attract scrutiny where other factors indicating the ability to exercise influence over policy are present.
- Other factors relevant to an assessment of a particular shareholding may include: the distribution and holders of the remaining shares; patterns of attendance and voting at recent shareholders' meetings; the existence of any special voting or veto rights attached to the shareholding under consideration; and any other special provisions in the constitution of the company conferring an ability materially to influence policy.
- An important factor in the OFT's assessment of material influence is whether the acquiring entity has or will have board representation. In this connection, the OFT will review the proportion of board directors appointed by the acquiring entity and the corporate/industry expertise exercised by members of the board appointed by the acquirer. This in turn requires assessment of the identities, relative experience and incentives of other board members.
- The OFT may also consider whether any additional agreements with the company enable the holder to influence policy. These might include the provision of consultancy services to the target or might, in certain circumstances, include agreements between firms

that one will cease production and source all its requirements from the other. Financial arrangements may confer material influence where the conditions are such that one party becomes so dependent on the other that it gains material influence over the company's commercial policy (for example, where a lender could threaten to withdraw loan facilities if a particular policy is not pursued, or where the loan conditions confer on the lender an ability to exercise rights over and above those necessary to protect its investment, say, by options to take control of the company or veto rights over certain strategic decisions).

2.11 There are no precise criteria for determining when an acquirer gains 'de facto' control of a company's policy; a view has to be taken case by case in the light of the particular circumstances. In general terms, the OFT is likely to reach a belief that merger arrangements give rise to a position of 'de facto' control when an entity is clearly the controller of a company, notwithstanding that it holds less than a 50.1 per cent voting stake in the target company. This might arise for example when an investor's industry expertise leads to its advice being followed in nearly all cases. 'De facto' control might also arise from an ability to veto any shareholder resolution requiring a supra-majority for adoption.

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

Acquiring control by stages

2.13 Should a shareholding that confers the ability materially to influence a company's policy increase subsequently to a level which amounts to 'de facto' control or a controlling interest, that further acquisition will produce another merger situation potentially liable to reference to the

CC. The same applies to a move from 'de facto' control to a controlling interest.

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

2.15 For the purposes of a merger reference, where a person acquires control of an enterprise (in any of the three senses described above) during a series of transactions within a single two-year period, the Act allows them to be considered as having occurred or occurring simultaneously on the date of the last transaction. In giving effect to this provision, the OFT may take into account transactions in contemplation (i.e. where the last of the events within the two-year period has not yet occurred).

Associated persons

2.16 For purposes of considering whether an enterprise has ceased to be distinct, the Act allows the OFT to consider whether a number of persons acquiring an enterprise are in fact 'associated persons' and thus should be viewed as acting together.

2.17 This situation will most commonly arise where the acquiring persons are related or have a signed agreement to act jointly to make an acquisition. It is also possible that separate entities may be considered to be 'associated persons' where they appear to have common incentives to act together for the purpose of gaining control over the acquired enterprise.

The turnover test

2.18 The 'turnover test' is satisfied where the annual value of the UK turnover of the enterprise being taken over exceeds £70 million.

[3] A partnership merger occurs where a full merger of A and B as equal partners is achieved by Newco C acquiring both. In this circumstance, neither A nor B survives the merger. Both firms are brought under common control, but neither remains under the same control as it was pre merger. The turnovers to be considered are those of A and B.

2.19 Generally, it will be straightforward to identify the acquired enterprise whose turnover should be taken into account. Where none of the enterprises remains under the same ownership and control, in a partnership merger or certain joint ventures for example, the value of the turnover of the enterprise being acquired will be calculated as the sum of the turnovers of the two enterprises ceasing to be distinct, less the turnover of the enterprise with the highest turnover.[3] In these cases, in practice, this means that the turnover of both of the enterprises ceasing to be distinct should exceed £70 million.

2.20 In principle, the turnover test applies to the turnover of the acquired enterprise that was generated by customers within the UK in the business year preceding the date of completion of the merger or, if the merger has not yet taken place, the date of the reference to the CC. The figures in the enterprise's latest published accounts will normally be sufficient to measure whether the turnover test is met, unless there have been significant changes since the accounts were prepared. In this circumstance, more recent accounts would provide a better guide to the actual turnover of the enterprises concerned. Where company accounts do not provide a relevant figure, for example because only part of a business is being acquired, OFT will consider evidence presented by the parties and other interested parties to form its own view as to what it believes to be the value of UK turnover for jurisdictional purposes.

2.21 The basic principles set out above will be elaborated in supplementary guidance to be published by the OFT on the application of the turnover test. This guidance will be published in June 2003.

The share of supply test

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

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

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

2.24 The Act allows wide discretion in describing the relevant goods or services, requiring only that, in relation to that description, the parties' share of supply or acquisition is 25 per cent or more. The share of supply test is not a market share test, thus the group of goods or services to which the jurisdictional test is applied need not amount to a relevant economic market. Generally, the OFT will have regard to the narrowest reasonable description of a set of goods or services to determine whether the share of supply test is met. In so doing, the OFT may have regard to the value, cost, price, quantity, capacity, number of workers employed or any other criterion in determining whether the 25 per cent test is met. This practice is intended to make it easier for companies and their advisers to determine whether the Act applies to a particular merger situation.

2.25 The share of supply test may be applied to the UK as a whole or to a substantial part of it. There is no statutory definition of 'a substantial part'. The House of Lords ruled in the context of similar provisions in the Fair Trading Act 1973 (FTA) that, while there can be no fixed definition, the area or areas considered must be of such size, character and importance as to make it worth consideration for the purposes of merger control.[4] Factors which have been taken into account in cases considered under the FTA include the size, population, social, political, economic, financial and geographic significance of the specified area or areas, and whether it is (or they are) special or significant in some way. The OFT expects to take similar factors into account under the Act.

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

3 Substantial lessening of competition

3.1 Save in certain limited circumstances, the OFT must refer a relevant merger situation to the CC for further investigation where the OFT believes that it is or may be the case that:

- a relevant merger situation has been created, or arrangements are in progress or contemplation which, if carried into effect, will result in the creation of a relevant merger situation, and
- the creation of that situation has resulted, or might be expected to result, in a substantial lessening of competition within any market or markets in the UK for goods or services.

(There are certain exceptions to the duty to refer which are described in chapters 7 and 8.)

3.2 The test for reference will be met if the OFT has a reasonably held belief that, on the basis of the evidence available to it, there is at least a significant prospect that a merger may be expected to lessen competition substantially.[5] The OFT considers that this threshold is the same as that against which FTA reference advices were prepared. It differs from that used by the CC in its merger enquiries, reflecting the fact that the OFT is a first-phase screen while the CC is determinative: hence, the test for making a merger reference is lower than the CC's test for deciding that a merger may be expected to substantially lessen competition.

[5] The evidentiary requirements are discussed elsewhere in this guidance and the OFT's *Mergers – procedural guidance* (OFT526).

3.3 This chapter of the guidance explains the general principles that the OFT will apply in seeking to identify mergers that it believes may be expected to result in a substantial lessening of competition. The OFT's interpretation of the concept of 'substantial lessening of competition' is first briefly explained, followed by an outline of the OFT's analytical framework. Later chapters of this guidance explain that framework in more detail, and also explain when the OFT may exercise discretion not to refer a merger to the CC for further investigation.[6]

[6] The CC publishes its own guidelines on merger analysis under the Act. Details of these are provided in chapter 13.

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

Introduction to substantial lessening of competition

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

3.6 Not all mergers give rise to competition issues. First, some mergers are either pro-competitive (because they positively enhance levels of rivalry) or are competitively neutral. Second, many mergers may lessen competition but not substantially, because sufficient post merger competitive constraints will remain to ensure that competition (or the process of rivalry) continues to discipline the commercial behaviour of the merged firm.

3.7 A merger may be expected to lead to a substantial lessening of competition when it is expected to weaken rivalry to such an extent that customers would be harmed. This may come about, for example, through reduced product choice, or because prices could be raised profitably, output could be reduced and/or product quality or innovation could be reduced.[7]

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

- **Horizontal mergers.**[8] Mergers between parties that operate in the same economic market can reduce competitive pressure on the merged firm to the extent that it could unilaterally impose a profitable post merger price increase or otherwise behave anti-competitively. Other firms in the market might unilaterally raise their prices in response, without any collusion among participants. Also, a merger might increase the likelihood (or stability) of coordination, either tacit or explicit, between the firms remaining in the market.[9]

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

[8] This is covered in detail in chapter 4.

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

- **Vertical mergers.**[10] Mergers between parties which operate at different levels of the supply chain of an industry, though often pro-competitive, may in some circumstances reduce the competitive constraints faced by the merged firm by foreclosing a substantial part of the market to competition (e.g. through refusals to supply, enhanced barriers to entry, facilitating price discrimination raising rivals costs) or by increasing the likelihood of post merger collusion. This risk is, however, unlikely to arise except in the presence of existing market power at one level in the supply chain at least, or in markets where there is already significant vertical integration/restraints.

- **Conglomerate mergers.**[11] Mergers between firms in different markets will rarely lessen competition substantially. But some such mergers might reduce competition, for example, through the exercise of portfolio power.

3.9 The application of the substantial lessening of competition test to these three types of merger is detailed in later chapters of this guidance. Set out below is a summary of the broad analytical elements that the OFT will review in seeking to identify mergers that may be expected to lessen competition substantially.

- The proper frame (or frames) of reference for analysing the immediate competitive constraints faced by the merged entity is identified by defining the relevant product and geographic markets affected by the merger.[12]

- The nature and extent of pre and post merger competition in the identified relevant markets may indicate concerns about a possible loss of rivalry as a result of the merger, particularly where the parties may be each other's closest competitors.[13]

- Where a merger gives rise to possible competition concerns, entry by new competitors or expansion by existing competitors may be sufficient in scope, timeliness and likelihood to deter or defeat any attempt by firms to capitalise on the loss of rivalry by exploiting customers. The rate of growth, relative maturity and dynamics of the relevant product and geographic market(s) may be factors that affect entry.

[10] Further detail is given in chapter 5.

[11] See also chapter 6.

[12] See paragraphs 3.11 to 3.22.

[13] The counterfactual is discussed further in paragraphs 3.23 and 3.24.

- Other factors, such as buyer power, might constrain post merger behaviour.
- Notwithstanding the loss of an independent market participant through the merger, rivalry within the market as a whole might be increased through the efficiency gains enjoyed by the merged entity.
- Where one of the merging parties is thought to be failing, judgment of whether the merger would result in a substantial lessening of competition will take account of what would otherwise happen to the assets and business of that firm without the merger.

3.10 The above principles should not be regarded as a mechanical framework for analysis. The process of identifying whether a merger might be expected to lead to a substantial lessening of competition considers the above factors in the round. Different factors may be given greater or less weight depending on the details of a given case and, in many cases, it may not be necessary to consider all of the above factors. The following sections of this guidance expand upon each of these factors.

Market definition

3.11 Proper examination of the competitive effects of a merger rests on a sound understanding of the competitive constraints under which the merged firm will operate. The scope of those constraints, if any, is identified through a market definition analysis. It is important to emphasise that market definition is not an end in itself. It is a framework for analysing the direct competitive pressures faced by the merged firm.

3.12 Relevant economic markets have two basic dimensions: products (or services) and geographic scope. The OFT has published a guideline on its methodology for identifying the scope of relevant product and geographic markets in cases under the Competition Act 1998.[14] Because broadly similar methodology is used to define markets in merger cases, reference should be made to that guideline. The following discussion of market definition is accordingly brief.

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

Demand-side and supply-side substitution

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

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

3.14 Because the concepts of the relevant market aim to capture the most immediate constraints on anti-competitive behaviour (whether in terms of the geographic or product dimension of the market), an important question in assessing the closeness of demand and supply-side substitution is the timeliness of customer and supplier responses to changes in relative prices. Only where such responses are sufficiently rapid to act as a short-term competitive constraint are the substitutes likely to be included in the relevant economic market.[15] The precise period to be taken into account will vary according to the facts of each case and the businesses concerned. In general terms though, the OFT would expect such short-term price constraints to be active within one year.

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

3.15 Similar questions of substitutability inform the assessment of geographic market definition. The more willing customers are to switch demand to firms located in a neighbouring area (or the more willing firms are to supply customers in neighbouring areas), the wider the geographic market is likely to be. The product and geographic dimensions of a market are often inter-linked. For example, an airline route has a geographic dimension. Although the OFT's responsibilities under the Act cover the UK, the relevant geographic market may be wider or narrower than the UK.

Testing for market definition

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

3.17 A widely used approach to assessing whether demand or supply-side switching is likely to discipline competitive behaviour in relation to a specific product is the hypothetical monopolist test. Here, a market is defined by asking whether it would be profitable for a hypothetical monopolist to impose a small, but significant (five to ten per cent), non-transitory increase in price (the SSNIP test) on a given product or group of products. Starting from the product or products immediately affected by the merger, further products are added to the group until a price increase of five to ten per cent would be profitable because customers would not switch away from the postulated group of products in sufficient numbers.

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

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

3.19 Where the OFT is able to use quantitative price data as a basis for the hypothetical monopolist test, it will generally use prevailing market price data. This is because a merger investigation focuses on whether prices could be raised above current levels, rather than whether current prices are too high.[16] There may however be cases in which the OFT will use other than prevailing prices, for example where future market prices can be accurately predicted on the basis of, say, changes in an industry's price regulation.

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

3.21 In some cases, a supplier may be using some of its capacity or production to meet its own internal needs. In the event of a rise in price on the open market, the supplier may decide to divert some or all of its 'captive' capacity or production to the open market if it is profitable to do so, taking into account effects on its downstream business that is now deprived of the captive supply. The extent to which 'captive' capacity or production is likely to be released onto the open market will be taken into account in assessing the competitive constraint.

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

[16] In Chapter II investigations under the Competition Act 1998, for example, the competitive prices version of the SSNIP test is used. An important aspect of these investigations is whether firms have market power. Where market power is being exercised, prices may be higher than they would be under competitive conditions, and rival products may appear to be closer substitutes than they actually are (the 'cellophane fallacy' named after a US case against E.I. du Pont de Nemours regarding pricing of cellophane). In such a situation, if the SSNIP test were based on prevailing prices, one might erroneously conclude that the firm under investigation did not have market power. In other words, the fact that the firm under investigation had used its market power to raise prices above competitive levels might, in certain circumstances, lead to the conclusion that it did not in fact have market power.

Identification of the correct 'counterfactual'

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

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

- where a firm is about to enter or exit the market.[17] Similarly, the OFT may also take account of committed expansion plans by existing competitors
- where changes to the regulatory structure of the market, such as market liberalisation, or tighter environmental constraints, will change the nature of competition.

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

4 Assessment of horizontal mergers

Introduction

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

Market structure and concentration

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

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

- **Market shares.** Shares are usually measured by sales revenue. Other measures, such as production volumes, sales volumes, capacity or reserves, may be used as appropriate (for example, where the product concerned is a traded commodity and production capacity therefore represents the best indication of competition strength). Current market shares may be adjusted to reflect expected and reasonably certain future changes, such as a firm's likely exit from the market or the introduction of additional capacity.[18] Comparison of the merged parties' market shares with those of other players in the market may give an indication of potential market power and whether the other players are able to provide a competitive constraint. Historic market shares can also provide useful insights into the competitive dynamics of a market: for example, volatile shares might suggest that there has been effective competition, equally, continuing high market shares are not always indicative of market power.
- **Concentration ratios (CRs).** CRs measure the aggregate market share of a small number (usually three (C3) or four (C4)) of the

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

leading firms in a market. They are absolute measures of concentration, taking no account of differences in the relative size of the firms that make up the leading group.

- **Herfindahl-Hirschman Index (HHI).** The HHI measures market concentration, but takes account of the differences in the size of the market participants. The HHI is calculated by summing the squares of the market shares of all the firms engaged in the market. The increase in HHI (or delta) can be calculated by subtracting the market's pre-transaction HHI from the expected post-transaction HHI.[19] Both the absolute level of the HHI and the expected change in the HHI as a result of the merger can provide an indication of whether a merger is likely to raise competition concerns. In some cases, the merger of smaller firms will increase the HHI but the merger may allow the merged firm to compete more effectively with its bigger rivals. The OFT is likely to regard any market with a post merger HHI in excess of 1800 as highly concentrated, and any market with a post merger HHI in excess of 1000 as concentrated. In a highly concentrated market, a merger with a delta in excess of 50 may give rise to potential competition concerns. In a concentrated market, a merger with a delta in excess of 100 may give rise to potential competition concerns. Where it is not possible to calculate HHI for the entire market (e.g. because not all participants' shares are known), the OFT will generally use other concentration measures or may, where appropriate, calculate only the incremental delta.

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

4.4 Each of these measures may be used as an initial indicator of potential competition concerns, but will not give rise to a presumption that a merger may be expected to lessen competition substantially. In other words, further investigation is always required to determine whether a merger will substantially lessen competition.

Possible anti-competitive effects of a horizontal merger

4.5 A horizontal merger is a merger between two firms active (or potentially active) in the same market at the same level of business (e.g. between two manufacturers, two distributors, or two retailers). When horizontal mergers occur, competition may be affected in a

number of ways. This loss of a competitor (actual or potential) can change the competitive incentives of the merging firms, their rivals, and their customers, leading to changes in the intensity of competition.[20] A merger can affect entry barriers and buyer power. The merging parties may themselves make efficiency gains as a result of the merger, and in some circumstances this could increase competition in the industry. To assess whether these changes will result in a substantial lessening of competition, the OFT will consider whether the merger has any of these effects and, in light of this assessment, consider whether sufficient post merger competitive pressure is expected to remain to ensure that the merged entity is not expected to be able to raise prices or reduce output profitably, or otherwise restrict choice/innovation.

4.6 There are two conceptually distinct means by which a horizontal merger might be expected to result in a substantial lessening of competition: non-coordinated effects and coordinated effects. Although they are conceptually distinct, it is possible that a single merger might raise both types of concern.

Non-coordinated effects

4.7 Non-coordinated effects, also referred to as unilateral effects,[21] may arise where, as a result of a merger, the merged firm finds it profitable to raise prices (or reduce output or quality) as a result of the loss of competition between the merged entities. This is because, pre-merger, any increase in the price of the acquiring firm's products would have led to a reduction in sales. However, post merger, any sales lost as a result of a price increase will be partially recaptured by increased sales of the acquired enterprise[22]. So sales lost will no longer be foregone. In addition, the firm may find it profitable to raise also the price of the acquired products, since it will recapture some of the lost sales through higher sales of its original products. Other firms in the market may also find it profitable to raise their prices because the higher prices of the merged firm's products will cause some customers to want to switch to rival products thereby increasing rivals' demand.

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

[21] The term 'unilateral effects' is sometimes misunderstood as referring to action by a single firm, in particular the merged entity. In fact it refers more generally to independent or non-coordinated action by market participants. For the sake of clarity we therefore use the term 'non-coordinated effects'. This unambiguously embraces not only the effect that a merger might have on (say) the pricing of the merging parties, but also possible effects on the pricing of other firms.

[22] In assessing whether a price increase would be profitable, it may also be necessary to take into account whether any reduction in sales would adversely affect a firm's cost base and so render the price increase unprofitable (e.g. because economies of scale were no longer being achieved).

4.8 Non-coordinated effects may arise where the market (or markets) concerned have a number of the following characteristics:

- there are few firms in the affected market(s)
- the merging parties are close competitors representing for a substantial number of customers the 'next best alternative' to each other's products, so a merger between the two will prevent those customers from switching to the best rival product in the event of a post merger price increase[23]
- customers have little choice of alternative suppliers, whether because of the absence of alternatives, switching costs, or the ability of suppliers to price discriminate
- it is difficult for rivals to react quickly to changes in price, output or quality, e.g. through product repositioning or supply-side substitution
- there is little spare capacity in the hands of the merged entity's competitors that would allow them to expand to supply customers in the event that the merged entity reduced output, and there is little prospect of expansion of existing capacity
- there is no strong competitive fringe capable of sustaining sufficient levels of post merger rivalry
- one of the merging firms is a 'maverick' – an important rivalrous force in the market representing a competitive constraint greater than its market share indicates, whose elimination may thus be an important change in competitive dynamics
- one of the merging firms is a recent new entrant or a strong potential new entrant that may have had a significant competitive effect on the market since its entry or which was expected to grow into an effective competitive force.

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

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

4.10 Though the profits from non-coordinated effects are generally captured by the merging parties, rival firms can also benefit from reductions in competitive pressure as a result of a merger. Even if rival firms pursue the same competitive strategies as they did prior to the merger, this can result in their increasing prices in the wake of a merger. In such cases, the firms in the marketplace are not coordinating their competitive behaviour (tacitly or explicitly); they are simply reacting independently to expected changes in each other's commercial behaviour. Such instances of anti-competitive effects are still termed 'unilateral' or non-coordinated by merger analysts since they are based on independent actions of firms. The change in the structure of the market may mean that other firms will behave differently and may react to an increase in prices by raising their own prices.

Coordinated anti-competitive effects

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

4.12 In order for tacit coordination to be successful or to become more likely, the OFT considers that three conditions must be met or be created by a merger:[24]

- the participants must have an ability to align their behaviour in the market
- the firms must have incentives to maintain the coordinated behaviour, which means detection of deviation from tacit

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

coordination and perhaps also credible 'punishment' of deviating firms through retaliatory behaviour by others, and

- the coordinated behaviour should be sustainable in the face of other competitive constraints in the market.

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

4.14 **Ability to align their behaviour in the market.** In order to coordinate tacitly firms need to achieve some kind of understanding as to how to do so. This need not involve an explicit agreement on what price to charge, market share quotas, or the quality of products to be attained. Nor is it necessary for the firms concerned to coordinate prices around the monopoly price, or for the coordination to involve every single firm in the market. However, it is sometimes possible for firms to find tacitly a 'focal' point around which to coordinate behaviour. Market transparency, product homogeneity, stability and symmetry (of size and cost) of the relevant firms are key elements in giving the firms the ability to align on terms of coordination.

4.15 **Incentives to maintain coordinated behaviour.** Though tacit coordination is in the collective interests of the oligopoly, it is often in firms' short-term individual interests to 'cheat' on the tacit coordination by cutting price, increasing market share, or selling outside 'accepted' territories. If coordinated behaviour is to be maintained, any such 'cheating' must be observable directly or indirectly. For tacit coordination to be sustainable the market concerned should therefore be sufficiently transparent that firms can monitor pricing and other terms of competition with a view to detecting cheating in a timely way and responding to it. Firms might have credible ways of 'punishing' any deviation from the tacit coordination, for example, by rapidly cutting prices or expanding output. More generally, it may be sufficient for coordinated behaviour that participating firms have a strong incentive not to deviate from the

coordinated behaviour, rather than that there is a particular punishment mechanism.

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

Entry and expansion

4.17 Entry by new competitors or expansion by existing competitors may be sufficient in time, scope, and likelihood to deter or defeat any attempt by the merging parties or their competitors to exploit the reduction in rivalry flowing from the merger (whether through coordinated or non-coordinated strategies).

New entry

4.18 New entry and the threat of entry can represent important competitive constraints on the behaviour of merging firms. If entry is particularly easy and likely, then the mere threat of entry may be sufficient to deter the merging parties from raising their prices since any price increase or reduction in output/quality would incentivise that new entry to take place.

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

4.20 First, the OFT will examine whether new entry may be expected to occur in the event that the merging parties seek to exercise market power. In this regard, the OFT may review:

- barriers to entry to the market (or markets) and the costs of entry to determine if new entry is in fact feasible,

- the experience of any firms that have entered or withdrawn from the relevant market or markets in recent years,
- evidence of planned entry by third parties, and
- the minimum viable scale needed for entry.

4.21 Entry barriers may be broadly defined as any feature of a market that gives incumbent firms an advantage over potential entrants, such that incumbents can persistently raise their prices above (or reduce quality below) competitive levels without new firms entering the market. In assessing the extent of such barriers, the OFT will consider absolute and strategic incumbency advantages, and the costs of entry.

- Absolute advantages include situations where government regulations, such as licensing, intellectual property rights, or preferential access to essential facilities limit the number of competitors that are able to enter a market.
- Strategic advantages arise where incumbent firms have advantages over new entrants because of their established position (first-mover advantages) or if incumbent firms are expected to behave strategically, for example, by responding to entry with very low prices or by investing in excess capacity or additional brands to deter entry.
- The costs of entering a market are more likely to deter entry where a significant proportion of those cost are sunk, i.e. the costs cannot be recovered if the entrant fails and is forced to exit. Sunk costs are the costs of entering a market that are not recoverable when exiting, and may include set-up costs (such as market research, finding a location and getting planning permission) but may also include costs associated with investment in specific assets, research and advertising or other promotion costs.
- Economies of scale arise where average costs fall as the level of output rises.[25] In some circumstances, such scale economies can act as a barrier to entry, particularly where the fixed costs are sunk. As a result, a new entrant may be deterred from attempting to match the costs of the incumbent by entering on a large scale, because of the risks that they would be unable to recover their sunk costs.

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

- The costs of entry must be considered against the expected revenues from sales and the time period over which costs might be recovered, to assess whether firms wanting to enter the market will find entry profitable and whether or not it may be difficult for them to raise such funds. In assessing whether entry would be profitable, the OFT will generally do so by reference to pre-merger prices since this is the price at which the merged entity would need to be constrained to avoid an indication of a substantial lessening of competition.
- The costs faced by customers in switching to a new supplier are also important in determining whether new entry would be an effective and timely competitive constraint.

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

4.23 Third, the OFT would also need to be satisfied that any such prospective new entry in response to any exercise of market power by the merged firm would be sufficiently timely and sustainable to provide lasting and effective post merger competition. Entry within less than two years will generally be timely, but this must be assessed on a case by case basis.

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

4.25 The effect of a merger on the possibility and/or likelihood of new entry might itself contribute to a substantial lessening of competition where a merger increases barriers to entry or otherwise reduces/eliminates the competitive constraint represented by new

entry. This might arise, for example, where the acquired entity was one of the most likely entrants or was genuinely perceived as such by those already in the market: in other words, the merger would substantially lessen pressure from potential competitors. In addition, in some markets, a merger might lead to 'tipping', where the parties' products (or services) would become adopted as the industry standard and competitive pressure may be significantly reduced as a result.

Expansion

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

Countervailing buyer power

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

- Most commonly, a buyer can simply switch, or credibly threaten to switch, its demand or a part thereof to another supplier. Whether buyers will maintain the same ability to choose among suppliers after the merger is a key issue.
- Even where a customer has (or customers have) no choice but to take the supplier's products, they may still be able to constrain prices if they are able to impose substantial costs on the supplier, e.g. by refusing to buy other products produced by the supplier or by delaying purchases, that they can use as leverage to defeat proposed price increases.
- Retailers may also be able to impose costs on the supplier through their own retail practices, e.g. by positioning the supplier's products in less favourable parts of the shop.

- Buyers might also threaten to enter the market themselves, or sell own-label products or could sponsor entry by others by covering the costs of entry, e.g. through offering the new entrant a long-term contract.[26]

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

Efficiencies

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

4.30 First, efficiencies may be taken into account where they increase rivalry in the market so that no substantial lessening of competition would result from a merger. For example, this could happen where two of the smaller firms in a market gain such efficiencies through merger that they can exert greater competitive pressure on larger competitors. Efficiencies in this sense are discussed in the following paragraphs because the OFT will take them into account in assessing whether a merger gives rise to any risk of a substantial lessening of competition.

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

4.31 Second, efficiencies might also be taken into account where they do not avert a substantial lessening of competition, but will nonetheless be passed on after the merger in the form of customer benefits. For example, if a merger would reduce rivalry in a market but proven efficiencies would be likely to result in lower prices to customers, the OFT would not take this into account in reaching a conclusion on the substantial lessening of competition test, but it might be a consideration under the customer benefits exception to the duty to refer. Efficiencies in this latter sense are discussed in chapter 7 of this guidance.

Efficiencies that increase rivalry

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

4.33 Efficiencies are defined broadly for purposes of this guidance. Hence possible efficiencies may include cost savings (fixed or variable), more intensive use of existing capacity, economies of scale or scope, or demand-side efficiencies such as increased network size or product quality.[27] Efficiencies might also encompass pro-competitive changes in the merged entity's incentives, for example by capturing complementarities in, e.g. R&D activity, which in turn might increase incentives to invest in product development in innovation markets.

4.34 In order for the OFT to take account of efficiencies that are claimed to enhance rivalry, they must be: (a) demonstrable; (b) merger-specific; and (c) likely to be passed on to customers.

- First, demonstrable efficiencies are efficiencies that can be shown to arise clearly and are very likely to arise: prospective efficiency gains are more easily claimed than achieved.

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

- Second, efficiency gains must be a direct consequence of the merger, i.e. they must be merger-specific. The key issue is that the analysis is incremental analysis, so that efficiencies must be judged relative to what would have happened without the merger.
- Third, the OFT must also be satisfied that there will continue to be sufficient post merger rivalry within the market to ensure that the merged entity has an incentive not only to pursue the claimed cost savings but also to pass on to customers a reasonable share of benefits.

4.35 For the reasons set out above, where mergers raise possible competition concerns, the OFT is generally sceptical, in the absence of compelling evidence, that efficiency gains will not only arise but will also be passed on to a sufficient extent to customers, especially where there are few remaining competitive constraints on the parties. Accordingly, in these situations, the evidence presented by the parties on efficiencies and their likely impact on rivalry must indeed be compelling. This is moreover the case because of the information asymmetries between the OFT and the merging parties in respect of efficiency claims. All of the information relating to such claims is in the hands of the merging parties so it is for them to demonstrate their case on the bases of the information available to them. Such evidence might, for example, include estimates and origin of likely cost-savings as evidence in pre-merger planning and strategy documents, coupled with objective factual and accounting information needed to verify proposed cost saving claims. External consultancy reports pre-dating the merger might also be helpful in this context.

Failing firm defence

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

4.37 In order to satisfy the failing firm defence against a finding of an expected substantial lessening of competition, the following conditions need to be met.

- First, in order to rely on a failing firm defence, the firm must be in such a parlous situation that without the merger it and its assets would exit the market and that this would occur in the near future. Firms on the verge of administration may not meet these criteria whereas firms in liquidation will usually do so. Decisions by profitable parent companies to close down loss-making subsidiaries are unlikely to meet this criteria.
- Second, there must be no serious prospect of re-organising the business. Identifying the appropriate counterfactual in these types of situation is often very difficult. For example, even companies in receivership often survive and recover.
- Third, there should be no less anti-competitive alternative to the merger. Even if a sale is inevitable, there may be other realistic buyers whose acquisition of the plant/assets would produce a better outcome for competition. These buyers may be interested in obtaining the plant/assets should the merger not proceed: that could indeed be a means by which new entry can come into the market. It may also be better for competition that the firm fails and the remaining players compete for its share and assets than that the failing firm's share and assets are transferred wholesale to a single purchaser.

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

4.39 Information that the OFT would request in order to give weight to a failing firm defence may include evidence:

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

5 Assessment of vertical mergers

Introduction

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

Market foreclosure

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

- If the merged entity is an important downstream customer for a product that it also supplies upstream, it may in certain circumstances be able to dampen competition from rival suppliers of that product by, for example, sourcing all of its future needs from its own production facility, thus jeopardising the continued existence of alternative upstream suppliers of the product.
- If a merged entity supplies a large proportion of an important input to a downstream process where it also competes, it may be able to dampen competition from its rivals in the downstream market for example by diverting all its production of the input to its own downstream process.
- If the merged entity refuses to supply a product to its downstream rivals, or by only selling the input to its rivals at a price that makes them uncompetitive, this might also foreclose competition.[28] This might be particularly relevant where firms in the downstream

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

market need to stock a full range of products to be competitive; hence, the loss of any product could harm their competitive prospects.

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

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

5.4 In assessing whether a merger could have foreclosure effects of this kind, it is important to consider the ability and incentives of the merged firm to foreclose in any market. In certain cases, the merged firm may have the ability to foreclose competition in some way, but lacks incentive to do so as such a strategy would not be profitable. The OFT is developing and will, where possible, use financial modelling and simulation techniques to assess whether foreclosure is likely to be profitable post merger.

Increased potential for collusion

5.5 In rare cases, vertical integration may facilitate collusion by increasing market transparency between firms.[29] Such concerns may arise, for example, where vertical integration affords the merged entity better knowledge of selling prices in another market, which facilitates tacit collusion in that market.

Countervailing factors

5.6 As with horizontal mergers, a firm's ability to exercise vertical market power may be constrained if there is buyer power or if barriers to entry are low. For example, if customers might in future be forced to

[29] See chapter 4 above for a discussion of collusion as a result of horizontal mergers. The same concepts apply here: alignment, market transparency, monitoring of adherence to the coordinated strategy, incentives not to deviate from that strategy, and competitive conditions conducive to coordination.

source all their requirements for a particular product from the upstream business of a competitor, the risk of such a situation arising might be alleviated if customers were sufficiently powerful either to resist price increases or to sponsor the emergence of a new supplier. More detail is given on buyer power and barriers to entry in chapter 4.

6 Assessment of conglomerate mergers

Introduction

6.1 Conglomerate mergers involve firms that operate in different product markets.[30] They may be product extension mergers (i.e. between firms that produce different but related products) or pure conglomerate mergers (i.e. between firms operating in entirely different markets). Such mergers rarely lead to a substantial lessening of competition as a result solely of their conglomerate effects. In a small number of cases, usually where the products acquired are complementary to the acquirer's own products, potentially adverse effects can be identified related to so-called 'portfolio power'.

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

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

Effect on market structure

6.3 Suppose, for example, that a merger creates a firm with many brands under its control. Where the brands relate to products that share sufficient characteristics to be considered a discrete group, customers may have an incentive to purchase the portfolio from one supplier to reduce their transaction costs. This circumstance may substantially lessen competition if non-portfolio competitors, or those competitors that control only one or a few brands, do not impose an effective competitive constraint on the firm(s) with 'portfolio power'. The circumstances in which such a lessening of competition might arise are discussed below.

Increasing the feasibility of anti-competitive strategies

6.4 Large conglomerates may seek to require or encourage customers to purchase a range of their products, whether through tying or bundling

of products or through significant discounts targeted at non-portfolio rivals' customers. A merger may give rise to a significant prospect that tying or bundling may occur if the merged firm controls complementary goods. Such conduct is likely to result in adverse effects on competition, however, only if it would be difficult for rivals or new entrants to provide competing bundles and thus be unable to constrain the behaviour of the merged entity which could then engage in profitable price increases, output reductions or other strategies.

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

Increased potential for coordination

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

Buyer power and barriers to entry

6.7 In assessing whether a conglomerate merger could have anti-competitive effects, the OFT, will of course, consider the ability of buyers to exercise countervailing power, and in particular the incentives of buyers to buy the portfolio from one supplier.[31] If it is the case that customers can and do source the portfolio products from multiple suppliers, and would likely continue to do so post merger, then it is unlikely that the merger would substantially lessen competition.

[31] Buyer power is discussed more fully in paragraphs 4.27 to 4.28.

6.8 As to the possibility of entry constraining the conglomerate supplier, the OFT will primarily consider whether another firm could replicate the portfolio of products offered by the merged entity. In this context, the OFT would also consider whether the creation of the portfolio of products itself represented a strategic barrier to entry and could limit the ability of competitors either to extend their portfolios or to enter new product markets.[32]

[32] Barriers to entry are discussed more fully in paragraphs 4.18 to 4.25.

7 Exceptions to the duty to refer

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

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

Merger insufficiently advanced

7.2 The intention of this provision is to avoid the unnecessary expense of reference where it is still uncertain whether the parties will proceed with the merger. In particular, this provision will ensure that the duty to refer is not triggered when the OFT is informed of transactions on a confidential basis. Hence, merging parties will not be inhibited from seeking informal advice or confidential guidance from the OFT.

7.3 The OFT would usually expect a transaction to be sufficiently advanced to justify reference where:

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

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

Markets of insufficient importance

7.5 The OFT may decide not to refer a merger to the CC if it believes that the market or markets in question are not of sufficient importance to justify the making of a reference. The purpose of this provision is to avoid references being made where the costs involved would be disproportionate to the size of the markets concerned. By way of guidance, at the time of writing the OFT would expect a CC inquiry to cost around £400,000. This exception is likely to apply only very rarely since in the majority of cases where a substantial lessening of competition is identified, it will be appropriate for the CC to investigate.

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

- where the product concerned is an important input into a larger market
- where the market is growing quickly, such that current market size is not a good reflection of the actual or potential importance of the market (particularly in new technology markets)
- where the goods or services concerned are considered essential to vulnerable consumers, or
- where the market is one of many smaller or local markets (for the goods or services concerned) that are together of considerable significance.

Customer benefits

7.7 For the OFT to exercise its discretion not to refer a merger on this basis, the claimed customer benefits must be clear and, in the case of cost savings, quantifiable.[33] In other words, the parties should be able to produce detailed and verifiable evidence of any anticipated price reductions or other benefits. Moreover, the OFT must believe that the claimed benefits will materialise within a reasonable period of time and must believe that such benefits would be unlikely to arise without the merger.

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

7.8 It is not sufficient to demonstrate that there are merely some theoretical benefits to customers: the merging parties 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. Illustrations of situations where such customer benefits might be weighed against the identified loss of competition include the following.

- **Lower prices.** A merger may, despite leading to a substantial lessening of competition, give clear scope for large cost savings through a reduction in marginal costs of production. In these circumstances, the merged firm – even if it is a monopolist – is likely to pass on some of this reduction in the form of lower prices to its customers.[34]
- **Greater innovation.** A merger might, in rare cases, facilitate innovation through R&D that could only be achieved through a certain critical mass, especially where larger fixed (and) sunk costs are involved. Exceptionally, the benefits likely to be passed through to customers from such innovation might outweigh the substantial lessening of competition.
- **Greater choice or higher quality.** One situation in which benefits of this kind might arise is where a merger increases the size of a network, and thus its value to customers.

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

[34] This is because a reduction in the monopolist's marginal costs will, assuming no change in the demand curve (or marginal revenue curve), increase its profit maximising level of output, leading to a reduction in price.

7.10 As noted in chapter 4 above, efficiency claims may fall for consideration in the substantial lessening of competition test and/or subsequently in relation to the customer benefits tests. To count as customer benefits, by definition, customers need to be better off with the merger, despite the fact that the OFT believes that the merger might lessen competition substantially. These will be rare cases since, ordinarily, the OFT would expect competition to deliver lower prices, higher quality and greater customer choice.

8 Undertakings in lieu of reference

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

8.2 The OFT can only accept undertakings in lieu of reference in cases where it has concluded that the merger should be referred to the CC.[35] Such a conclusion must be published and the reasons for reference identified. Any undertakings must be aimed at remedying or preventing the adverse competition effects identified. In considering any such undertakings, the OFT will seek to achieve undertakings in lieu that are sufficient to address clearly the identified adverse competition effects and are proportionate to them. The OFT will also seek to agree undertakings that preserve any merger-specific customer benefits. However, the OFT will not accept undertakings in lieu of reference that do not address the identified competition effects but which are designed instead to 'lock in' sufficient customer benefits to outweigh the risks of a substantial lessening of competition arising.

[35] In other words, undertakings in lieu are only available where the OFT has concluded that a reference is required; and where the exceptions to the duty to refer are not applicable. Accordingly, the OFT will only accept undertakings in lieu to address the underlying competition concerns and not to enhance any perceived customer benefits.

8.3 In order to accept undertakings in lieu of reference, the OFT must be confident that the competition concerns identified can be resolved by means of undertakings without the need for further investigation. Undertakings in lieu of reference are therefore appropriate only where the competition concerns raised by the merger and the remedies proposed to address them are clear cut, and those remedies are capable of ready implementation. It is for this reason that undertakings in lieu have typically been used in merger cases in the past where a substantial lessening of competition arises from an overlap that is relatively small in the context of the merger (e.g. a few local markets affected by a national merger).

8.4 In cases in which there is doubt over the precise identification of the substantial lessening of competition or in which the effectiveness or proportionality of the proposed undertakings in lieu may be questioned, the OFT considers it unlikely that the 'clear cut' criteria mentioned above would be met. In these circumstances, acceptance of undertakings in lieu would not be appropriate.

8.5 An acquiring company can always take the initiative to propose suitable undertakings if it thinks that they may be appropriate to meet any competition concerns that it foresees. In such cases the company may be willing to resolve the problem by divesting itself of part of its business (a structural undertaking); alternatively, in order to remove the concerns that have been raised, it may give a formal commitment about its future conduct (behavioural undertakings). Alternatively, the OFT may invite companies to consider whether they want to offer undertakings where it believes that it is or may be the case that a merger may raise competition issues potentially warranting reference and which seem amenable to remedy by undertakings in lieu.

Structural undertakings

8.6 A merger involves a structural change to a market. A structural solution will therefore often be the most appropriate remedy if the OFT believes that it is or may be the case that a merger may (or may be expected to) result in a substantial lessening of competition. The OFT considers that structural undertakings are more likely to be accepted as undertakings in lieu than behavioural undertakings because they clearly address the market structure issues that give rise to the competition problems.

8.7 Typically, structural undertakings require the sale of one of the overlapping businesses that have led to the concern about competition. Ideally, this should be a self-standing business, capable of being fully separated from the merging parties, and in most cases will be part of the acquired enterprise. The sale should be completed within a stated period (usually a maximum of six months). After that an independent trustee may be appointed, at the owner's expense, to monitor the operation of the business pending disposal and/or to handle the sale if the owner has not completed the divestiture within the specified period.

8.8 Before approving the sale of any business as a remedy, the OFT will approve the buyer. This is to ensure that the proposed buyer has the necessary expertise, resources and incentives to operate the divested business as an effective competitor in the market place. If that is not the case, it is unlikely that the proposed divestiture would be an effective remedy for the anti-competitive effects identified.

8.9 In appropriate cases, the OFT will consider other structural or quasi-structural undertakings in lieu of reference. For example, divestment of the buyer's existing business (or part of it) might be appropriate, although in such cases the OFT will also need to consider the competition implications of the asset swap. Alternatively, a remedy such as an amendment to intellectual property licences might in some circumstances be appropriate.

Behavioural undertakings

8.10 Behavioural undertakings can provide a means of moderating the scope for a merged company to behave anti-competitively. The OFT will consider behavioural undertakings where it considers that divestment would be impractical, or disproportionate to the nature of the concerns identified. However, given that structural undertakings are more likely to remedy any competition concerns identified since they address structural changes in the marketplace from which the competitive effects flow, the OFT is unlikely to consider generally that behavioural undertakings have sufficiently clear effects to address the identified competition concerns. Behavioural undertakings may sometimes also be necessary to support structural divestment.

Public interest cases

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

9 Special provisions for mergers in certain industries

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

Newspapers

9.2 The assessment and decision on newspaper mergers are presently the responsibility of the Secretary of State under the Fair Trading Act 1973, with prior written consent from the Secretary of State being required for any merger which concentrates, in the hands of one newspaper proprietor, newspapers with an average paid-for circulation of 500,000 copies or more per day of circulation.[36] Except in certain limited circumstances, the Secretary of State cannot give consent to the transfer of ownership of the newspaper until the CC has investigated and reported on the proposed merger: there is therefore an automatic reference to the CC in most newspaper cases. It is a criminal offence to proceed with a newspaper merger without consent, or to breach any conditions attached to consent.

[36] A 'newspaper proprietor' is any person who either owns a newspaper or controls directly or indirectly at least one-quarter of the voting rights in a company owning a newspaper

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

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

Communications Bill

9.5 At publication date, the Communications Bill is still before Parliament. The Bill proposes that, in future, all newspaper mergers will be

examined by the OFT in the same way as other mergers under the Act, but that the Secretary of State will have the ability, if she so wishes, to issue an intervention notice if she considers that public interest considerations such as plurality and diversity of the media might be relevant to the merger decision.

Where the Secretary of State does not issue an intervention notice

9.6 In the event that the Secretary of State does not issue an intervention notice, it is proposed that the OFT will determine whether or not the merger should be cleared (or referred to the CC for further investigation) on competition grounds, on the same basis as any normal merger.

Where the Secretary of State issues an intervention notice

9.7 In the event that the Secretary of State issues an intervention notice, it is currently proposed that the following process will apply:

- the OFT will provide definitive advice to the DTI on the jurisdictional and competition issues, which the DTI is obliged to accept
- Office of Communication (OFCOM) will provide advice on matters relating to newspaper plurality and diversity, but the DTI will have discretion as to whether it accepts this advice
- appropriate 'gateways' will allow the OFT to liaise with OFCOM and exchange information as required.

9.8 The Secretary of State will decide whether or not to refer a merger in the light of advice provided by the OFT and OFCOM. Advice from the OFT and OFCOM will be published following the DTI decision on the merger. References can be made on either competition or public interest grounds (or both). Alternatively, the Secretary of State may decide that the public interest issues outweigh the substantial lessening of competition concern, or justify lesser undertakings in lieu of a reference.

- If the Secretary of State concludes that public interest factors are not significant, she may make a decision on competition grounds, in accordance with the OFT's advice.
- If the Secretary of State considers that there are no public interest issues, she may return the case to OFT for decision.

9.9 If a reference is made on public interest grounds (with or without competition grounds) the Secretary of State will also make the final decision on the merger after the CC has issued its report on the merger.

9.10 It is also envisaged that, exceptionally, a newspaper merger which does not qualify under the normal merger tests may raise public interest concerns. Such mergers are not subject to competition scrutiny, but the Secretary of State may issue an intervention notice. If so, OFCOM will advise on plurality issues and a reference may be made, or undertakings agreed on public interest grounds.

For advice on newspaper mergers, contact:

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

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

Water or sewerage undertakings

9.11 In some circumstances, mergers of water or sewerage undertakings are subject to mandatory reference to the CC. Under the Water Industry Act 1991 the Secretary of State must refer any merger involving two or more 'water enterprises' if the gross assets of both the target and at least one of the water enterprises of the acquirer exceeds £30 million. (A 'water enterprise' is an enterprise carried on by a water or sewage undertaking appointed under section 6 of the Water Industry Act 1991.) The OFT has a duty to advise the Secretary of State on whether a water merger meets the criteria for reference.

Before doing so, it also consults the Director General of Water Services.

9.12 The Act has modified the Water Industry Act 1991 so that the OFT must refer any merger involving two or more 'water enterprises' if the UK turnover of the target water enterprise exceeds £10 million or if the acquiring firm already owns water enterprises that each have turnover exceeding £10 million.[37] The OFT will consult the Director General of Water Services and the parties before making such a reference, taking account of whether, in the case of an anticipated merger, the arrangements are sufficiently far advanced to warrant reference or are sufficiently likely to proceed.

[37] No data has yet been set when these provisions of the Act will come into force.

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

Regulated utilities

9.14 There are no special provisions under UK merger legislation for regulated utilities such as electricity, gas, telecommunications or rail. In principle, therefore, mergers in regulated industries are subject to the Act in the same way as any other merger. However, a merger in a regulated industry may well require the modification of an operating licence or give rise to other issues falling within the expertise of the relevant regulator. For this reason, the OFT and the sectoral regulators work closely together on mergers in regulated industries. In some cases, the regulator may issue a consultation document in respect of the merger, the responses to which will inform the views offered to the OFT by the regulator. Neither the OFT nor the Secretary of State (in public interest cases) will be bound by the regulator's views, but they would pay close attention to them since the regulator may comment on matters where they have greater expertise than the OFT.

10 Public interest cases

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

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

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

10.4 The OFT will perform its competition investigation in the usual way to determine whether or not it believes there is a relevant merger situation and, if so, whether or not it believes that the merger situation might substantially lessen competition. If the OFT believes that the merger might have this effect, it will further consider whether any of the exceptional grounds for not making a reference (described in chapters 7 and 8) are satisfied in the case. The OFT will then report its findings on jurisdiction and the competition issues – together with a summary of any representations received on the public interest issues – to the Secretary of State. The OFT will not usually make any recommendation on the public interest matter

because comment on such issues lies outside its competition expertise.

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

- If the Secretary of State considers that public interest issues are material to the outcome of the case, she may clear the transaction (even if the OFT has advised its belief that the merger may be expected to substantially lessen competition), make a reference to the CC, or ask the OFT to seek undertakings in lieu of a reference. In each case, the decision may take account of a combination of public interest and competition issues, or be based on public interest elements only. The Secretary of State will be required to publish reasons for public interest decisions.
- If the Secretary of State considers that public interest issues are not material to the outcome of the case, she will return the case to the OFT, which will make a decision consistent with its advice on competition issues. This may be a clearance, undertakings in lieu, or a reference – in each case on competition grounds.

Special merger situations

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

summary of any comments received on public interest issues in respect of that merger.

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

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

Introduction

11.1 Agreements and conduct that give rise to a merger, as well as any restrictions that are 'directly related and necessary to the implementation or the attainment of the merger' (ancillary restrictions), are generally excluded from the prohibitions in the Competition Act 1998. Schedule 1 to the Competition Act 1998 excludes agreements and conducts that give rise a relevant merger situation within the meaning of the Act, and also any restrictions that are 'directly related and necessary to the implementation of the merger'. A merger does not have to qualify for reference to the CC to benefit from the exclusion: in other words, mergers that do not meet the jurisdictional thresholds set out in the Act (discussed in chapter 2 above) still benefit from this exclusion.

11.2 The aim of the exclusion is to prevent agreements or conduct from being subject to control under both the Competition Act 1998 and the merger provisions of the Act, and also to prevent agreements giving rise to mergers from being subject to control under the Competition Act 1998 when it was not thought necessary to control them under the merger provisions of the Act.

Exclusion for mergers

11.3 Under Schedule 1 to the Competition Act 1998, an agreement does not fall within the scope of the Chapter I prohibition to the extent that it gives rise to a merger situation. Similarly, to the extent to which conduct results in a merger situation, the conduct does not fall within the scope of the Chapter II prohibition.

11.4 As explained in chapter 2, a merger situation can arise where two or more enterprises cease to be distinct from each other. This usually occurs when they are brought under common ownership or common control, which allows the OFT to review transactions that

confer on the acquirer: (a) the ability materially to influence the policy of the company, (b) the ability to control the policies of the company without having a controlling interest, or (c) a controlling interest in the company. The level of control relating to a particular merger is relevant to the Schedule 1 exclusion as it is one of the factors which determines whether the benefit of the exclusion can be withdrawn.

Withdrawal of the exclusion

11.5 To ensure that the exclusion does not allow significantly anti-competitive transactions to escape scrutiny altogether, it can be withdrawn in certain limited circumstances. Schedule 1 includes a mechanism which allows the OFT to give a direction withdrawing the benefit of the exclusion from the Chapter I prohibition in relation to specified agreements. It may, however, give a direction only in certain limited circumstances, as set out below, and not at all in respect of those newspaper mergers that are currently dealt with exclusively by the Secretary of State nor in respect of those mergers which fall within the EC Merger Regulation. There is no provision for the exclusion to be withdrawn in relation to the Chapter II prohibition.

11.6 The OFT may only withdraw the benefit of the exclusion where the agreement is not a 'protected agreement' and the OFT considers that:

- it will otherwise infringe the Chapter I prohibition, and
- it is unlikely that the OFT would grant it an unconditional individual exemption.[38]

11.7 An agreement is protected if:

- the OFT or (as the case may be) the Secretary of State has published a decision not to refer the agreement to the CC under the merger provisions of the Fair Trading Act or the Act
- the OFT or (as the case may be) the Secretary of State has referred the agreement to the CC which has confirmed that it gives rise to a relevant merger situation or a special merger situation

[38] The availability of exemptions in the future is subject to implementation of the EC modernisation regime in the UK. See DTI Consultation document, Modernisation – a consultation on the Government's proposals for giving effect to Regulation 1/2003 EC and for re-alignment of the Competition Act 1998 /8 April 2003), available at: www.dti.gov.uk/ccp/consultpdf/compmodcom.pdf.

- it does not fall into either of the above categories but gives rise to enterprises ceasing to be distinct as a result of the acquisition of a controlling interest, but not as a result of the acquisition of control of policy or material influence, or
- it has been referred to the CC under section 32 of the WIA and the CC has confirmed that the agreement gives rise to a merger of two or more water enterprises to which that section applies.

11.8 One effect of these provisions is that the OFT can withdraw the benefit of the exclusion only where the merger situation results from the acquisition of material influence or control of policy (in other words, it is not an acquisition of a controlling interest) and the merger has either (a) been found not to qualify for investigation under the Act or (b) not been brought to the OFT's attention.

11.9 In practice, it is likely that the exclusion will be withdrawn only rarely. This is because, even where an agreement is not protected, the OFT must believe that the agreement will infringe the Chapter I prohibition in the Competition Act 1998 and is unlikely to qualify for an unconditional exemption before it can withdraw the benefit of the exclusion. To infringe the Chapter I prohibition, the agreement must have an appreciable effect on competition which is generally unlikely to be the case where the combined market share of the parties to the agreement is less than 25 per cent.

11.10 The procedure for withdrawing the benefit of the exclusion is described in annexe B to the OFT's publication *Mergers – procedural guidance*.

Exclusion for ancillary restrictions

11.11 Many merger cases involve the acceptance of restrictions which go beyond the merger agreement itself. A seller of a business, for example, sometimes accepts a non-competition obligation which prevents it from competing with that business. Where such restrictions are **'directly related and necessary to the implementation of'** the merger agreement, they are known as

ancillary restrictions, and are covered by the Schedule 1 exclusion, whether or not the merger qualifies for investigation by the CC.

11.12 The concept of ancillary restrictions is well developed under the EC Merger Regulation, which provides that ancillary restrictions are covered by any decision declaring a merger to be **'compatible with the common market'** (that is, a clearance decision). This provision aims to avoid the need for parallel proceedings under Council Regulation 4064/89 (as amended) (the EC Merger Regulation) and Articles 81 and/ or 82 of the EC Treaty. The merger provisions of the Act and Schedule 1 to the Competition Act 1998 will have a similar effect. Thus, if restrictions are ancillary to a merger, they will not fall to be considered under the Competition Act 1998.

The OFT's approach

11.13 The OFT's approach to ancillary restrictions generally follows the European Commission's Notice on restrictions directly related and necessary to concentrations,[39] as this constitutes a statement of the European Commission to which the authorities must have regard under section 60 of the Competition Act 1998. One important clarification is that the OFT will consider requests for ancillary status if requested to do so. As the OFT's practice of applying the Schedule 1 exclusion develops, the OFT may issue additional guidance on the treatment of ancillary restrictions.

[39] European Commission Notice on restrictions directly related necessary to concentrations – OJ 2001 C 188/5, 4 July 2001.

Definition of ancillary restrictions

11.14 Schedule 1 provides that a restriction must be directly related and necessary to the implementation of the merger if it is to benefit from the exclusion.

11.15 In order to be directly related, the restriction must be connected with the merger, but ancillary or subordinate to its main object. For example, the main object of a merger agreement may be for one company to buy a particular manufacturing operation from another. The added obligation of supplying raw materials to enable the manufacturing operation to continue is directly related to the merger agreement, but subordinate to it.

11.16 Any contractual arrangements which go to the heart of the merger, such as the setting up of a holding company to facilitate joint control by two independent companies of a new joint venture company, are not characterised as subordinate. Such arrangements are part of the merger agreement itself and will form part of the assessment of the merger under the Act.

11.17 A restriction is not automatically deemed directly related to the merger simply because it is agreed at the same time as the merger or is expressed to be so related. If there is little or no connection with the merger, such a restriction will not be ancillary.

11.18 In addition to deciding whether a restriction is to be considered to be directly related, it must also be established whether it is necessary to the implementation of the merger. This is likely to be the case where, for example, in the absence of the restriction the merger would not go ahead or could only go ahead under more certain conditions, at substantially higher costs, over an appreciably longer period, or with considerably higher difficultly. In determining the necessity of the restriction, account will also be taken of whether its duration, subject matter and geographical field of application are proportionate to the overall requirements of the merger. The OFT will consider all these factors in the context of each case.

Examples of ancillary restrictions

11.19 Although the answer to the question whether a restriction satisfies the requirements of the Schedule 1 exclusion depends on the circumstances of each case, it is possible to set out some general principles on how commonly arising restrictions (e.g. non-compete clauses, licences of intellectual property and know-how, and purchase and supply agreements) will be handled.

11.20 **Non-competition clauses.** Such clauses often arise in the context of an acquisition by one undertaking of all or part of another undertaking. Such clauses, if properly limited, are generally accepted as essential if the purchaser is to receive the full benefit of any goodwill and/or know-how acquired with any tangible assets. The terms of the clause must not, however, exceed what is necessary to

attain that objective. The OFT will consider the duration of the clause, its geographical field of application, its subject matter and the persons subject to it. In general terms, a three year period will normally be acceptable where both goodwill and know-how have been acquired, and a period of two years where only goodwill is involved. Longer periods may be acceptable depending on individual circumstances. Any restriction must relate only to the goods and services of the acquired business and apply only to the area in which the relevant goods and services were established under the previous/current owner.

11.21 **Licences of intellectual property and know-how.** Where an undertaking acquires the whole or part of an undertaking, the transaction includes the transfer of rights to intellectual property or know-how. In some instances the seller may need to retain ownership of such rights to exploit them in the remaining parts of its business. In such cases, the purchaser will normally be guaranteed access to the rights under licensing arrangements. In this context, restrictions in exclusive or simple licences of patents, trade-marks, know-how and similar rights may be accepted as necessary to the implementation of the merger, and therefore covered by the definition of ancillary restrictions in the Competition Act 1998. The licences may be limited in terms of their field of use to the activities of the business acquired, and may be granted for the entire duration of the patents, trade-marks of similar rights, or the normal economic life of any know-how recorded earlier. If the licences contain restrictions, not within any of the above categories, they are likely to fall outside the definition of an ancillary restriction.

11.22 **Purchase and supply agreements.** Purchase and supply agreements may be acceptable where an acquired business was formerly part of an integrated group of companies and relied on another company in the group for raw materials, or where it represented a guaranteed outlet for the company's products. In such circumstances, purchase and supply agreements between the new and former owners may be considered ancillary for a transitional period so that the businesses concerned can adapt to their new

circumstances. Exclusivity will not, however, be acceptable save in exceptional circumstances.

11.23 **Other types of restriction.** Restrictions other than the three above categories may be considered ancillary. There may be other types of restrictions that are directly related and necessary to the implementation of a merger and which may, therefore, be covered by the Schedule 1 exclusion, depending on the circumstances of the particular case.

11.24 The procedure for establishing whether a restriction is ancillary to a merger is also described in annexe B to the OFT's publication *Mergers – procedural guidance*.

12 Interaction with EC merger control regime

12.1 Mergers above a certain size fall outside the scope of the Act's jurisdiction. Instead, they are notifiable to the European Commission's Directorate General for Competition in Brussels under the EC Merger Regulation, and in general terms the UK regime may not be applied to such mergers. Mergers fall under the jurisdiction of the European Commission when they satisfy one of two alternative sets of jurisdictional thresholds:

Either

- the combined worldwide turnover of the merging parties exceeds € 5 billion

and

- the combined EU-wide turnover of each of at least two of the parties to the merger exceeds € 250 million

unless

- each of the merging parties achieves more than two-thirds of its aggregate Community-wide turnover within one and the same Member State.

or

- the combined worldwide turnover of the merging parties exceeds € 2.5 billion

and in each of at least three Member States:

- the combined turnover of the merging parties is € 100 million
- at least two parties to the merger each has a turnover of more than € 25 million

and within the EU as a whole:

- at least two parties to the merger each has a combined turnover of more than € 100 million

unless

- each of the merging parties achieves more than two-thirds of its aggregate Community wide turnover within one and the same Member State.

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

12.3 The OFT fulfils a number of the functions of the UK's competent authority under the EC Merger Regulation. This includes liaison with the European Commission on the assessment and determination of cases notified to the European Commission. It also includes deciding when to request a case back from the European Commission in whole or in part under Article 9 of the EC Merger Regulation, and when to seek to refer a case to the European Commission under Article 22.

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

12.5 The OFT is most likely to request that a case be referred back from the European Commission when: it concerns entirely or largely the United Kingdom or a market within the United Kingdom; the OFT and the CC have experience in reviewing the market or markets in question; and where the assets concerned by the transaction are located in the United Kingdom so that if, ultimately, a remedy is required, it would be possible for the UK authorities to secure that remedy.

12.6 A Member State or Member States may under Article 22 request that the European Commission take over review of a transaction

where it does not meet the thresholds for notification the European Commission (see paragraph 12.1 above) but may (a) affect trade between Member States and (b) create or strengthen a dominant position as a result of which effective competition would be significantly impeded in the territory of the Member State or States making the referral request. Accordingly, it is possible that certain mergers notified to the OFT under the Act may be referred to the European Commission for consideration.

12.7 The OFT will consider referring a case to the European Commission where, in addition to meeting the technical requirements of Article 22, it is apparent that the European Commission is the best-placed authority to review the merger. This will in particular be the case when the assets concerned by the transaction are located outside the United Kingdom, so that it would be difficult for the UK authorities to obtain a remedy in the event that the merger is found to raise competition concerns.

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

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

12.10 Information concerning the procedures that the OFT will follow in exercising the functions described above is provided in chapter 9 of the OFT's '*Mergers – procedural guidance*'.

13 Further information

13.1 Further information can be obtained from:

The Mergers Branch
Office of Fair Trading
Fleetbank House
2-6 Salisbury Square
London EC4Y 8JX

Tel: 020 7211 8915/ 8917/ 8918
Fax: 020 7211 8916

and from the OFT's website (www.oft.gov.uk)

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

13.3 The OFT has published a number of Research Papers that may provide useful background information. These papers report the findings of projects commissioned by the OFT as part of its ongoing programme of research into aspects of UK Competition and Consumer Policy. The intention is that research findings should be made available to a wider audience of practitioners, both for information and as a basis for discussion. Views expressed in such Research Papers are those of the authors and may not necessarily reflect the views of the OFT. Nor should they be treated as guidance issued as a consequence of the OFT's obligation to publish general advice and information under the Act.

13.4 Research Papers of particular relevance to mergers include:

OFT Research Paper 2, *Barriers to entry and exit in UK competition policy*, March 1994

OFT Research Paper 12, *Vertical restraints and competition policy*, December 1996

OFT Research Paper 16, *The welfare consequences of the exercise of buyer power*, September 1998

OFT Research Paper 19, *Merger appraisal in oligopolistic markets*, November 1999

13.5 All OFT Research Papers are available, free of charge, from:

Office of Fair Trading, PO Box 366, Hayes, UB3 1XB
Tel: 0870 60 60 321, Fax: 0870 60 70 321,
e-mail: oft@echristian.co.uk

OR

online at www.oft.gov.uk

13.6 The CC has published its own guidelines on the substantive test for merger analysis. These guidelines are available at: www.competition-commission.org.uk/inquiries/CC2.pdf

Enterprise Act publications

Throughout 2003 the OFT is issuing a series of guidance booklets on various aspects of the Act. New guidance may be published and the existing guidance revised from time to time. For an up-to-date list of guidance booklets:

check www.oft.gov.uk/enterpriseact.htm
email enterpriseact.enquiries@oft.gsi.gov.uk
or telephone Enterprise Act enquiries on 020 7211 8181

All guidance booklets can be ordered or downloaded from the OFT's website http://www.oft.gov.uk/enterpriseact.htm. Or you can request them by:

phone 0870 60 60 321
fax 0870 60 70 321
email oft@eclogistics.co.uk
post EC Logistics, Swallowfield Way, Hayes, Middlesex UB3 1DQ

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