



INTERNATIONAL COMPETITION NETWORK

**Proposed Recommended Practices for Merger
Analysis**

Prepared by

The Merger Working Group

**Presented at the 8th Annual Conference of the ICN
Zurich, June 2009**

IV. Competitive Effects Analysis in Horizontal Merger Review: Overview

- A. The goal of competitive effects analysis in the review of horizontal mergers is to assess whether a merger is likely to harm competition significantly by creating or enhancing the merged firm’s ability or incentives to exercise market power, either unilaterally or in coordination with rivals.**

WORKING GROUP COMMENTS

Comment 1: Agencies should conduct competitive effects analysis in merger review to identify those mergers likely to harm competition significantly by creating or enhancing market power. When exercised by sellers, market power is the ability profitably to raise price above competitive levels for a significant period of time, and/or to lessen competition on parameters other than price, such as quality, service, or innovation. In some cases, market power may be exercised by buyers. In such cases, market power is the ability profitably to reduce the price paid to suppliers below competitive levels for a significant period of time, which may in some cases lead to an anticompetitive reduction in supplier output.

Comment 2: Agencies generally should conduct competitive effects analysis within the context of properly defined product and geographic markets. However, market definition is not an end in itself but is a tool to assist in determining whether a merger will create or enhance market power. In some cases, evidence of competitive effects, such as price effects following a consummated merger under investigation or a prior merger in the industry, may inform the analysis of the appropriate relevant markets.

Comment 3: Agencies engaged in competitive effects analysis should conduct a forward-looking inquiry focusing on a comparison of the anticipated state of competition in the relevant market(s) with and without the merger. An agency’s assessment of competition without the merger (sometimes called the “counterfactual”) should be informed not only by the existing conditions of competition, but also by any significant changes in the state of competition likely to occur without the merger.

Comment 4: While changes in market share or market concentration are useful indicators of potential competitive concerns, competitive effects analysis involves a comprehensive assessment of market conditions, and provides agencies with a more reliable means to assess potential harm to competition than changes in market share or market concentration alone.

- B. In conducting competitive effects analysis, agencies should consider whether a merger likely will result in anticompetitive unilateral or coordinated effects. These two theories of competitive harm provide the analytical frameworks for determining whether a horizontal merger may be expected to harm competition significantly.**

WORKING GROUP COMMENTS

Comment 1: Unilateral effects, also known as non-coordinated effects, arise when, as a result of a merger, it is likely that the merged firm, without any coordination with non-merger rivals, will be able profitably to exercise market power to a materially greater degree than would have been possible for either of the merged firms before the merger.

Comment 2: Coordinated effects arise when, as a result of a merger, it is likely that firms remaining in the market after the merger will be able to coordinate (either tacitly or explicitly) their behavior or strengthen existing coordination in order to exercise market power.

Comment 3: Unilateral effects and coordinated effects are broad analytical frameworks designed to encompass the full range of anticompetitive effects that may result from horizontal mergers. While anticompetitive effects of a merger within a particular market are often best characterized as either unilateral or coordinated, a merger may result in both unilateral and coordinated effects.

- C. The analysis of competitive effects under either the unilateral or coordinated effects framework should be clearly grounded in both sound economics and the facts of the particular case.**

WORKING GROUP COMMENTS

Comment 1: Economic theories and models are useful in analyzing competitive effects under both unilateral and coordinated effects frameworks, but only to the extent that the theory or model used to assess the likely competitive effects of a merger is based on sound and robust economic principles and fits the factual conditions of the market to which it is applied.

Comment 2: Competitive effects analysis depends heavily on the specific facts of each case. In conducting competitive effects analysis, agencies should refine their theories or models of likely competitive harm in light of the available qualitative and quantitative evidence. Qualitative evidence often comes from documents or first-hand observations of the industry by customers or other market participants. Quantitative evidence is often derived from statistical analysis of price, quantity, or other data related to, among other things, prior market events (sometimes called “natural experiments”) involving incumbent responses to prior events such as entry or exit by rivals. Competitive effects analysis should be flexible enough to adapt over time to evolving markets, business practices, and economic learning

V. Unilateral Effects

- A. **In analyzing the potential for a horizontal merger to result in anticompetitive unilateral effects, agencies should assess whether the merger is likely to harm competition significantly by creating or enhancing the merged firm's ability or incentives to exercise market power independently.**

WORKING GROUP COMMENTS

Comment 1: Horizontal mergers eliminate any competitive constraint that the merging parties formerly exerted upon one another. In the majority of mergers, this has no significant adverse effect on competition because there are other sufficient competitive constraints on the merged entity. In some cases, however, the elimination of competition between the merging parties in itself may create or enhance the ability of the merged firm independently to exercise market power, depending on market conditions, including the existence and effectiveness of other competitive constraints.

Comment 2: Agencies conducting unilateral effects analysis should look not only at market shares and market concentration, but should also examine the specific features of the market that affect the merged firm's ability to exercise market power. While market shares are a useful indicator of the potential for the merged firm to exercise unilateral market power, market shares alone may overstate or understate the potential for a merger to result in anticompetitive unilateral effects. Competitive constraints may preclude the exercise of market power even by firms with high market shares. On the other hand, even small changes in market share in some circumstances may increase the ability or incentives of a firm to exercise market power.

- B. **In conducting unilateral effects analysis, agencies should apply the economic theory or model that best fits the characteristics of the market(s) at issue.**

WORKING GROUP COMMENTS

Comment 1: Mergers may increase the likelihood of the exercise of unilateral market power in a variety of settings. There are a number of unilateral effects theories and models in the economic literature that address competitive effects in specific factual settings. While the specific model or theory used will vary depending on the characteristics of the market, all are designed to assess whether there is any material increase in unilateral market power as a result of the merger. Common theories and models include, but are not limited to:

- *Merger to monopoly:* A merger that would combine the only two rivals in a properly defined market raises a high risk of significant anticompetitive unilateral effects. In examining a merger combining the only two rivals in a relevant market, agencies should assess whether any competitive constraints exist, such as ease of entry, that would preclude the unilateral exercise of market power by the merged firm.

- *Merger of competitors in differentiated product markets:* A merger that would combine competing suppliers of differentiated products may raise the potential for significant anticompetitive unilateral effects if a sufficient proportion of consumers view the products combined by the merger as their first and second choices (or closest substitutes). Commonly used sources of evidence on the degree of substitutability among differentiated products include marketing surveys, analysis of purchasing patterns, cross-price elasticities, and information contained in normal course of business documents from market participants. Agencies should assess whether the merger would allow the merged firm profitably to increase price on one or more products after the merger, or whether sufficient customers would switch to products of other competitors so as to render such a price increase unprofitable for the merged firm. Agencies should also consider whether rival sellers likely would replace any loss of competition by repositioning or extending their product lines to compete more closely with the merged firm.
- *Merger of competitors in undifferentiated product markets:* In examining a merger that would combine competing suppliers of undifferentiated products in markets in which firms are distinguished primarily by capacity, agencies should consider whether the merged firm would find it profitable to raise price by reducing output below the level that would have prevailed absent the merger. The exercise of market power in such markets is likely only if competitors of the merged firm likely would not respond to the price increase and output reduction by the merged firm with increases in their own outputs sufficient in the aggregate to make the unilateral action of the merged firm unprofitable. This may occur if non-merging firms face binding capacity constraints that could not be economically relaxed in a timely manner, or if existing excess capacity is significantly more costly to operate than capacity currently in use. In such cases, competitors may find it more profitable to raise price than expand output, resulting in additional anticompetitive unilateral effects.
- *Merger of rivals in bidding or auction markets:* A merger that would combine rival bidders in bidding or auction markets may raise the potential for significant anticompetitive unilateral effects. There are a variety of models in the economic literature addressing a wide array of bidding and auction formats involving both differentiated and undifferentiated products. For example, some models focus on whether the merger would combine the two lowest-cost or otherwise closest competitors. Other models focus on whether the merger would result in a competitively significant reduction in the number of bidders. Agencies should determine the appropriate model depending upon the circumstances of the market, and each bid or auction market should be analyzed on its own facts.

Comment 2: Merger simulation and other formal economic modeling can be useful tools in unilateral effects analysis. In order to be useful, the particular model used should be based on sound and robust economic principles, fit the facts of the market, and suitable data must exist to calibrate the model. The fit of a model should be based on the totality of the evidence.

C. In conducting unilateral effects analysis, agencies should assess the competitive constraints and other factors relevant to the ability of the merged firm to exercise market power in the relevant market(s).

WORKING GROUP COMMENTS

Comment 1: In assessing the impact of a merger on the merged firm's ability to exercise market power, agencies should draw on all available evidence, especially evidence created in the ordinary course of business. Common sources of evidence include documents, information, quantitative evidence, and economic analyses from the merging parties, customers, competitors, and other third parties; statements, representations, and testimony from representatives of the merging parties and other industry participants; and generally available industry studies, reports, and market data.

Comment 2: Agencies should assess whether competitive constraints or other market conditions that will remain in the market following the merger are adequate to prevent the creation or enhancement of unilateral market power. Factors that are often relevant in assessing the likelihood of a unilateral exercise of market power as a result of a merger include, but are not limited to:

- *Availability and Responsiveness of Alternative Suppliers:* If alternative suppliers (offering adequate substitutes and with sufficient available capacity) will remain post-merger, and a significant number of customers are willing and able to turn to these alternative suppliers in the event of an anticompetitive increase in price, the threat of losing such customers may be enough to deter the exercise of market power by the merged firm.
- *Entry, Repositioning, or Expansion:* The prospect of entry by new competitors, or expansion or repositioning by existing competitors, may be sufficient in time, scope, and likelihood to deter or defeat any attempt by the merged firm to exercise market power.¹ In some cases, however, a merger may lessen the potential for entry, expansion or repositioning to act as a competitive constraint against the exercise of market power.

¹ Recommended Practices on the analysis of entry and expansion are contained in section III of the ICN Recommended Practices for Merger Analysis.

- *Buyer Power:* In some circumstances, customers may have the incentive and ability to defeat the exercise of market power through their bargaining strength against the seller because of their size, commercial significance to the seller, or ability to switch to alternative sources of supply. Customers also may have the ability to encourage or sponsor competitive entry or expansion, or to produce the relevant product themselves. In such cases, even firms with very high market share may not be in a position to exercise market power post-merger. To prevent significant anticompetitive effects, however, buyer power must constrain the exercise of market power in the market and not merely protect certain individual customers.
- *Efficiencies:* Agencies should carefully assess any substantiated claims by the merging parties that a merger will generate efficiencies sufficient to prevent or mitigate anticompetitive unilateral effects from the merger. For instance, cost reductions may reduce a merged firm's incentive to raise price. Efficiencies may also result in benefits in the form of new or improved products, even when price is not immediately and directly affected. Agencies should consider the impact of substantiated efficiencies that are unlikely to be achieved in the absence of the merger on the merged firm's ability and incentives to compete, and whether such efficiencies may preserve or intensify competition, thereby benefiting consumers.

VI. Coordinated Effects

- A. **In analyzing the potential for a horizontal merger to result in coordinated effects, agencies should assess whether the merger increases the likelihood that firms in the market will successfully coordinate their behaviour or strengthen existing coordination in a manner that harms competition significantly.**

WORKING GROUP COMMENTS

Comment 1: To identify those mergers that materially enhance the likelihood of coordination or strengthen existing coordination, agencies should: (a) assess whether market conditions are conducive to coordination in the relevant market(s) affected by the merger; and (b) analyse specifically whether and how the merger would affect market conditions and firms' ability or incentives that would make coordination more likely post merger.

Comment 2: The fact that a market has conditions that are conducive to coordination in itself is not sufficient to conclude that a merger is likely to further or enhance coordination. Agencies should also be able to determine whether the merger will make coordination easier or more likely, considering the specific features of the market that affect the merged firm's ability and incentives to exercise market power in coordination with rivals.

Comment 3: Changes in market concentration and market share are relevant, but not determinative, factors in assessing whether a merger is likely to further or enhance coordinated interaction. Agencies should focus on whether the merger will materially alter firms' ability or incentives to achieve and sustain coordination. An examination of the role each competitor plays in the competitive dynamics of the market may help to determine how the merger is likely to impact the likelihood of coordination post-merger.

- B. In conducting coordinated effects analysis, agencies should assess whether the conditions that are generally necessary for successful coordination are present: (a) the ability to identify terms of coordination, (b) the ability to detect deviations from the terms of coordination, and (c) the ability to punish deviations that would undermine the coordinated interaction.**

WORKING GROUP COMMENTS

Comment 1: Coordinated behaviour can take many forms: it may be tacit or explicit and may or may not be lawful in itself. In some markets, firms may coordinate their behaviour on prices in order to keep them above the competitive level. In other markets, firms' coordination may aim at limiting production or the amount of new capacity brought to the market. Firms may also coordinate by dividing the market, for instance by geographic area or other customer characteristics, or by allocating contracts in bidding markets.

Comment 2: In order to coordinate, firms need to achieve an understanding as to how to do so. This need not involve explicit agreements among competitors, or any communication between them, nor need it involve all firms or perfect coordination between firms. Agencies should assess whether it is likely that participants could achieve terms of coordination that would be sufficiently successful to result in significant harm to competition. When assessing market conditions conducive to reaching terms of coordination, important factors include, but are not limited to:

- The number of firms in a market, since it is easier to coordinate among a few players than among many;
- The existence of frequent and regular orders, which make it easier to coordinate and to detect deviations from the terms of coordination;
- The homogeneity of the products, since it is easier to coordinate on terms such as price when competing products are substantially the same;
- The homogeneity of the firms, especially in terms of symmetry of market shares, similarity of cost structures, levels of vertical integration, and the impact that such homogeneity may have on their ability or incentives to coordinate;
- The degree of transparency of important information that could provide a focal point for coordination, such as information concerning prices, output, capacity, customers served, territories served, discounts, new product introductions, etc.;
- Cross-shareholdings and other links that may make it easier for competitors to exchange information on terms of coordination, and may reduce their incentives to compete; and,
- Other market conditions: for instance, it is easier to coordinate on price when demand and supply conditions are relatively stable than when they are frequently changing (e.g., because of the ease of entry by new firms or rapid, significant product innovations).

Comment 3: Firms may be able to identify terms of coordination even in markets with complex product characteristics or terms of trade. For instance, in a market with many

differentiated products, firms may still be able to coordinate on prices by establishing simple pricing rules that reduce the complexity of coordinating on a large number of prices or to coordinate on terms other than prices. Moreover, coordination may not necessarily be achieved on all dimensions of competition.

Comment 4: Although coordination may be in the collective interest of participants, it is often in a firm's individual interest to deviate from the terms of coordination in order to take advantage of the profit opportunity created when other firms raise their prices or otherwise coordinate their behaviour. For coordination to be maintained, participants must have the ability to detect and respond to deviations from the terms of coordination. Agencies should assess the extent to which firms would have the ability to monitor the important terms of coordination and to detect deviations from the terms of coordination in a timely manner. When assessing the likelihood and timeliness of detection of deviations from the coordinated behaviour, important factors include, but are not limited to:

- The degree of transparency of important information necessary to verify compliance by other firms with the terms of coordination, such as information concerning other firms' pricing, output levels, or individual transactions. For instance, if orders for the relevant products are regular both in terms of frequency and size, it may be difficult for a firm to deviate (by expanding its output) without being detected. Also, if there is little fluctuation in demand or costs, deviations may be easier to detect. On the other hand, if orders for the relevant products are infrequent and large, firms may have a greater incentive to deviate to secure orders and the threat of later punishment may not serve as an effective deterrent.
- The extent to which the homogeneity or heterogeneity of the products and firms may make monitoring of compliance with the terms of coordination and detection of deviations more or less difficult.

Comment 5: In order to deter deviations from the terms of coordination, firms must have the ability to punish deviations in a manner that will ensure that coordinating firms find it more profitable to adhere to the terms of coordination than to deviate, given the cost of reprisal. Punishment may take many forms, including temporary abandonment of the terms of coordination by other firms in the market. In assessing whether there will be a sufficiently credible and severe punishment when a deviation by one of the firms is detected, important factors include, but are not limited to:

- The effectiveness of the deterrent mechanism itself: e.g., the threat of expanding output to punish a deviating firm may not be credible or effective if coordinating firms have no or little excess capacity;
- The speed with which the deterrent mechanism can be implemented, given that reprisal that manifests itself after some significant time lag is less likely to be sufficient to offset the benefits from deviating; and,
- The costs of implementing the deterrent mechanism compared to the long-term benefits of coordination.

Other factors, such as the presence of the same firms in several markets (sometimes called “multi-market contacts”), may also be of relevance in determining the likelihood of sufficiently credible and severe punishment.

- C. In conducting coordinated effects analysis, agencies should assess the extent to which existing competitive constraints and other factors would likely deter or disrupt effective coordination. In making this assessment, agencies should consider all available evidence, including the pre-merger market conditions that may constrain or facilitate successful coordination, and the impact of the merger on these conditions.**

WORKING GROUP COMMENTS

Comment 1: Agencies should assess whether competitive constraints or other market conditions that will remain in the market following the merger are adequate to prevent the creation or enhancement of coordinated interaction. Factors that are often relevant in making this assessment include, but are not limited to:

- *Past Coordination/Behaviour of Firms:* In assessing the likelihood of coordinated effects, agencies should take into account information on the pre-merger characteristics of the markets concerned, including the past behaviour of firms. Evidence of past coordination is important and may serve as strong evidence that all three conditions for successful coordination are present if the relevant market characteristics have not changed appreciably or are not likely to do so in the near future.
- *Entry or Expansion:* Agencies should also consider the actions of competitors not expected to participate in the coordination (“non-coordinating competitors”) and potential competitors, which may be sufficient in time, scope, and likelihood to jeopardise the outcome expected from coordination.² For instance, the existence of non-coordinating competitors with the ability to expand capacity to take sales from coordinating firms may deter or disrupt coordination. Agencies should therefore consider the existence and significance of barriers to entry and expansion into the relevant market(s) since low barriers to entry and expansion may render successful coordination unlikely or impossible.
- *Maverick Firm:* Coordination may also be difficult to sustain in the presence of a maverick firm – a firm with a different competitive strategy and a greater economic incentive than its rivals to deviate from the terms of coordination. Particular care is needed in mergers involving the acquisition of a maverick firm because in some circumstances those mergers may eliminate a significant constraint to effective coordination and make coordinated interaction more likely, more successful, or more complete.

² Recommended Practices on the analysis of entry and expansion are contained in section III of the ICN Recommended Practices for Merger Analysis.

- *Buyer Power:* Agencies should consider whether the actions or characteristics of customers affect the likelihood of successful coordination. In some circumstances, buyers may be able to undermine coordinated behaviour, for example by sponsoring entry or expansion. Where large buyers likely would engage in long-term contracting, so that sales covered by such contracts would be large relative to a firm's total output, firms may have a greater incentive to deviate from the terms of coordination.
- *Efficiencies:* Agencies should carefully assess any substantiated claims by the merging parties that a merger will generate efficiencies sufficient to prevent or mitigate coordinated effects from the merger. For instance, cost reductions may enhance a merged firm's incentives to lower prices, thus reducing incentives to coordinate. Efficiencies may also result in benefits in the form of a new or improved product that could undermine coordination. Agencies should consider the impact of substantiated efficiencies that are unlikely to be achieved in the absence of the merger on the merged firm's incentives to coordinate.

Comment 2: In assessing market conditions conducive to coordination, competition authorities should bear in mind that no single factor or group of factors is always determinative.