Presentation on Combination Assessment

Internal Training Programme

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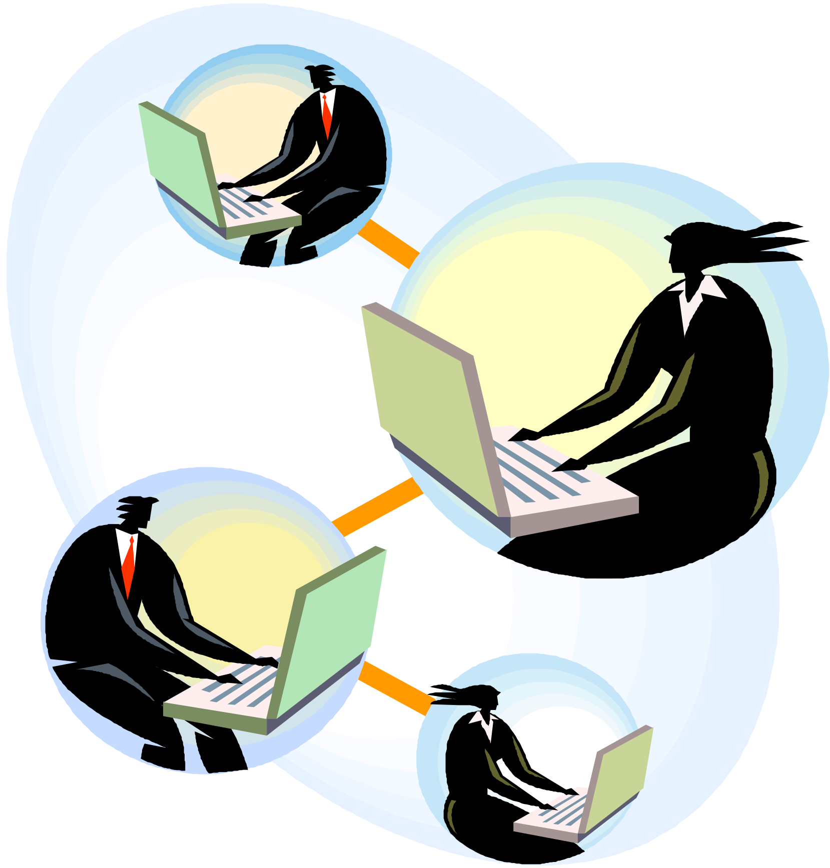
Kinds of Combinations

- Horizontal
- Vertical
- Conglomerate



Horizontal Combinations

- Combination between competitors
- At same level in production or distribution chain in relevant market
- Increases market share post-combination
- Reduces number of competitors in market
- Main concern of a competition law
- Focus of this presentation

Vertical Combinations

- Combination involving firms engaged at different stages of production or distribution chain
- No direct loss in competition
- Potentially generate substantial efficiencies
- May result in market foreclosure by excluding competitors from upstream or downstream markets
- Two-level entry required to compete

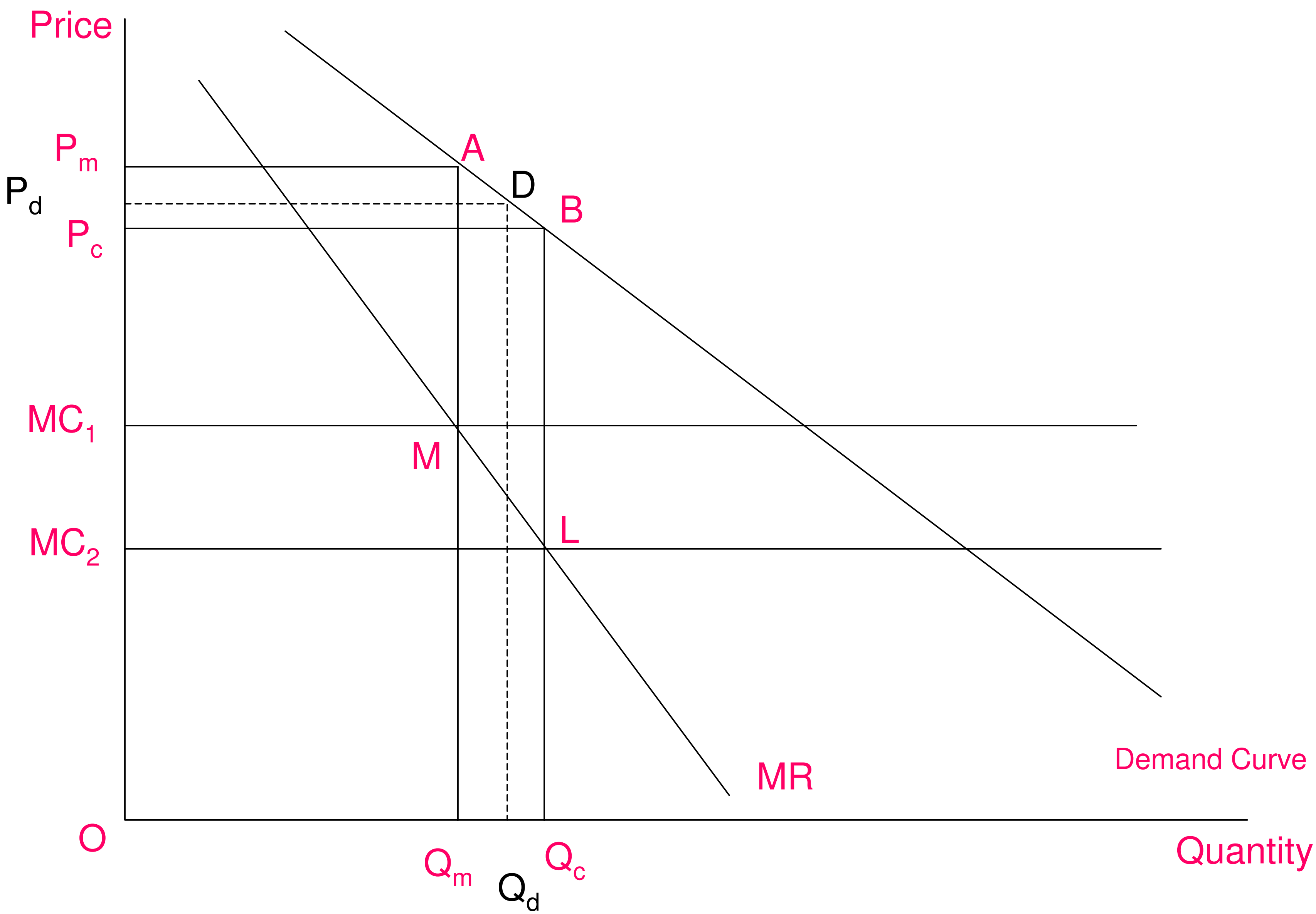
Conglomerate Combinations

- Combination between firms engaged in activities that have neither a horizontal or vertical relationship
- No competition problem in majority of cases
- Focus on combinations in closely related markets with customer overlaps
- Effects on competition through portfolio power, leveraging & bundling or other exclusionary practices

Effects of Combinations

- ICN summarizes the position as follows
- Most combinations do not harm competition
- Some may, indeed, be pro-competitive
- Many others are competitively neutral
- In some situations, combinations can have anticompetitive effect

Economic Theory of Combination



International Law-US

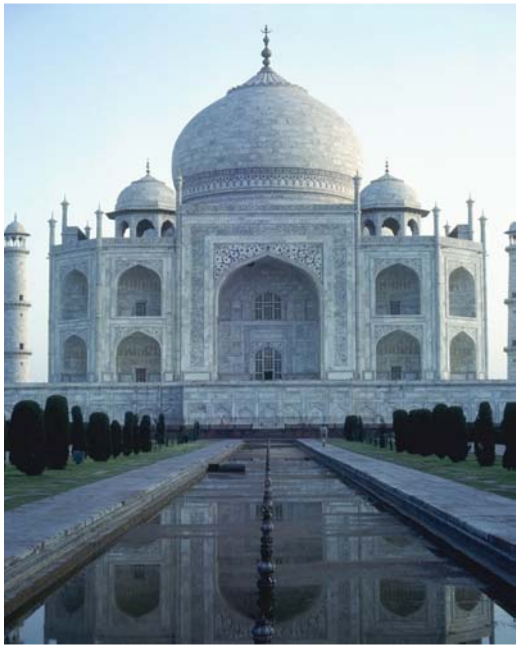
- Section 1 Sherman Act,1890 prohibits mergers if they constitute contract, combination or conspiracy in restraint of trade
- Sec. 7 of Clayton Act,1914 prohibits mergers that lead to substantial lessening of competition (SLC) or tend to create monopoly
- US 1992 Horizontal Merger Guidelines- mergers not permitted to create or enhance market power or to facilitate its exercise

International Law-EC

- Art.2 of ECMR(1989) focused on concentration which creates or strengthens dominant position (single firm or collective dominance)
- New ECMR(2004) prohibits concentration which significantly impede effective competition as a result of creation or strengthening of dominant position
- Dominant position – economic power to act to considerable extent independently of competitors, customers and ultimately consumers

Competition Act, 2002

- Prohibits combination which causes or likely to cause an appreciable adverse effect on competition (AAEC) within relevant market in India
- 14 factors for evaluation of AAEC provided (8 factors from TPA, 1974 Australia & 3 from CA, 1985 Canada)
- Unlike US or EC, no direct reference to creation or strengthening of either dominant position or monopoly

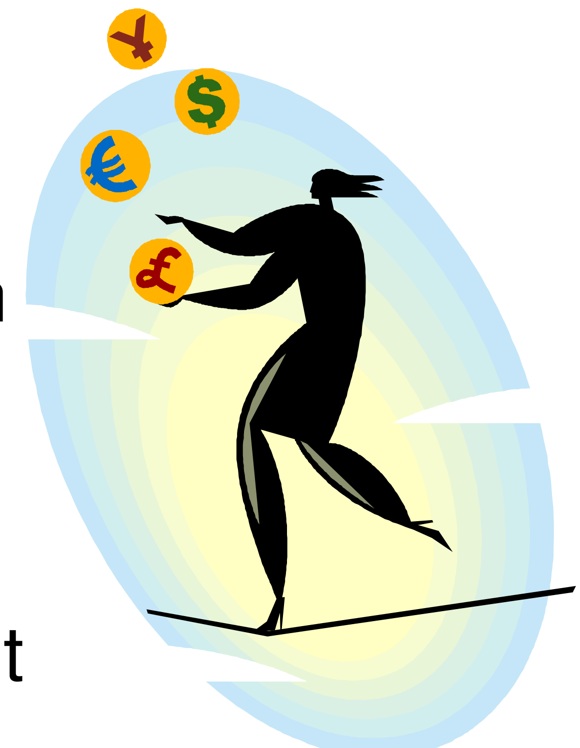


Combination Assessment

- Two-step approach
- First-define relevant market (product & geographic)- [sec.19]
- Second-identify likely adverse competitive effects in the relevant market-[sec.20]
- Assessment of factors or conditions leading to or restraining “unilateral” or “coordinated” effects of combination
- Public guidelines issued in US (since 1968, present 1992- revised 1997) & EC (2004) for analytical framework of merger assessment

Theories of Harm

- Mainly two theories of consumer or competitive harm
- Unilateral (non-coordinated) effects and coordinated effects (collective dominance) theories
- Substantial factual analysis needed in support of assessment
- Comparison of competition with or without combination (counterfactual)
- Counterfactual also takes into account likely & imminent changes in market without combination- expansion plans



Market Power

- US: Ability of firm profitably to maintain prices above competitive levels for significant period of time (economic definition)
- EC: Substantial market power ~ Dominant position
- Power to reduce output or quality or variety
- Market power~ (relative) market share
- Combination creates or strengthens market power or facilitates its exercise

Measuring Market Power

- Lerner Index (L)
- L= MSC/ [EMD + ESC(1-MSC)]
- MSC- Market Share of Combination
- EMD- Elasticity of Market Demand
- ESC- Elasticity of Supply of competitors

Unilateral Effects

- Merger to monopoly-2 firms combining to have 100% market share
- Non-collusive oligopoly – Cournot & Bertrand model
- Where combined firm can exercise market power independently
- Exercise of market power is not dependent on collusion by competitors
- EC-creation or strengthening of dominant position (single firm dominance)
- US-ability to profitably raise price

Factors in Unilateral Effects

- Merging firms have large market shares
- Merging firms are close competitors- first & second choice of consumers
- Competitors unlikely to increase supply if prices increase
- Merged entity able to hinder entry or expansion by competitors
- Customers have limited possibilities of switching supplier –switching costs
- Eliminates an important competitive force – recent entrant / innovator

Coordinated Effects

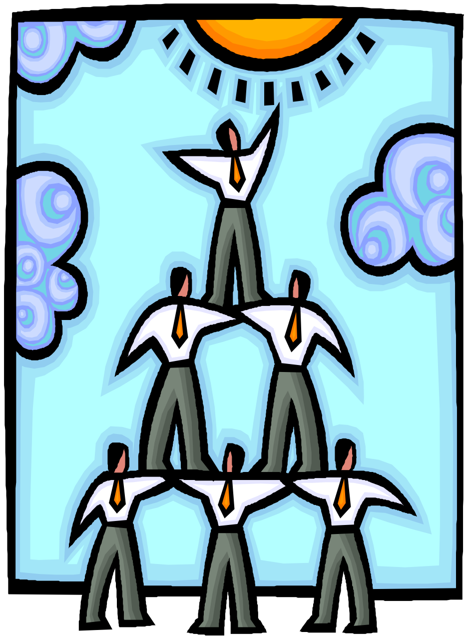
- Ability of competitors to coordinate their competitive behaviour by profitable accommodating reactions
- Can take various forms-coordination on price, output, market allocation
- Express or tacit collusion which may not necessarily be cartel conduct
- Also called collective dominance in EC
- Certain market conditions, structural features & past behaviour important

Conditions for Coordination-I

- Three conditions necessary for sustainable coordination
- First condition- profitable terms of coordination for participants
- Easier for fewer firms to coordinate
- Easier to coordinate in cases of- product homogeneity, stability of firms & symmetry in cost structure in terms of market shares, capacity levels & level of vertical integration

Conditions for Coordination-II

- Second condition- means to detect deviations that would undermine coordination
- Lower the number of firms, higher the transparency of market transactions
- Exchange of information through trade associations, publication of information or announcements
- Cross-holdings or directorship, joint ventures make monitoring easier



Conditions for Coordination-III

- Third condition- deterrent mechanisms
- Consequences of deviations to be sufficiently severe
- Sufficient certainty of deterrent mechanism
- Price war or increasing output significantly to entail ST loss
- Retaliation possible in other markets of commercial interaction

Combination Key

hc-abg-jdil-n-k-ef-m?

Market Shares (h)

- Pre-merger and post-merger shares compared
- Starting point for assessment (along with concentration) in US & EC
- Other factors considered afterwards if to challenge a merger
- Higher market share=greater market power (US) or dominance (EC)
- EC-evidence of dominance if market shares >50% but compatible if <25%
- US- presumption if market share >35% with first & second choice products

Market Share Measurement

- Market share in terms of sales, production or capacity in relevant market (US)
- Either in monetary or in physical terms
- Firm's future competitive significance is accounted for in market shares
- Normally based on annual data but longer period also taken
- Importance of market definition in determining market share-Staples case

Level of Concentration (c)

- Function of number of firms in market & their respective market shares
- Indicator of competitive pressure within market or relative market power
- Based on S-C-P doctrine
- Initial indicator but not determinative
- Higher concentration- possibility of higher Cournot price equilibrium-higher unilateral effect
- Higher concentration-possibility of larger coordinated effects

Concentration Ratios

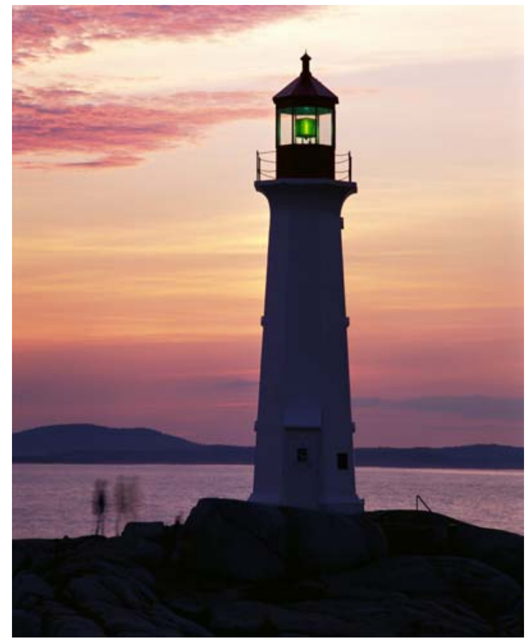
- CR3/CR4/CR5
- CR3: 25+15+30=70
- Absolute Measure of concentration
- Only for a number of firms
- No account of relative size of firms
- If CR4: Combination between 5th & 6th largest will show no change
- 1968 US guidelines in CR4 terms
- Now US & EC Guidelines do not provide explicitly for this measure

Herfindahl-Hirschman Index

- HHI ranges between 0 (infinite number of firms) to 10000 (monopolist)
- Relative size of firm relevant
- Higher weight to larger firms
- Pre and post combination HHI increase measured by delta
- Pre:20+20+20+20+10+10=1800
- Post:30+20+20+20+10=2200
- Delta=400 (change in concentration)
- Information on whole of the market
- Can be approximated for smaller players

Safe Harbours -US

- US merger guidelines provide for general standards (& safe harbours)
- Following cases-unlikely to have anticompetitive effects & ordinarily require no further analysis in US
- Post-merger HHI <1000
- HHI: 1000-1800 but delta <100
- HHI>1800 but delta<50
- Otherwise merger considered to raise significant competitive concerns & analysis of other factors is required



Safe Harbours -EC

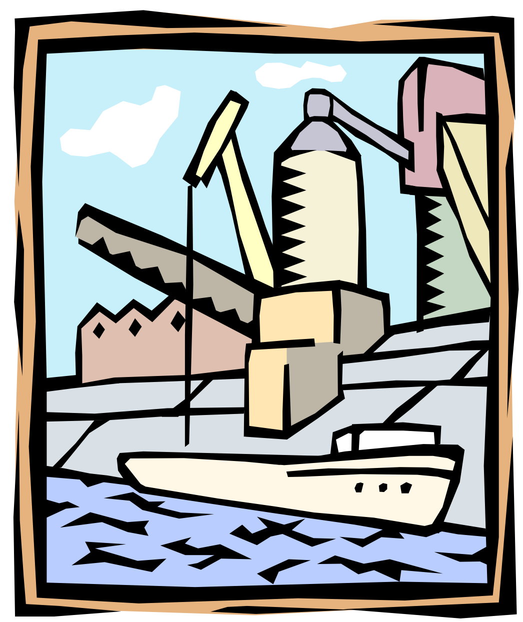
- EC merger guidelines- Commission unlikely to identify competition concerns & extensive analysis not required in following cases
- Post-merger HHI <1000
- HHI: 1000-2000 & delta <250 or HHI>2000 & delta <150 except in special circumstances such as-
- Merger with potential or recent entrant, important innovator, cross-shareholdings, maverick firm, past or ongoing coordination or pre-merger market share >50% of one of parties

Competition through Imports (a)

- In US & EC, imports (or foreign firms) are accounted for in geographic market definition (or in market shares)
- If geographic market defined as world, imports are not an issue
- Competition Act,2002- AAEC in relevant market in India [sec.6 & 20]
- Effect of imports assessed after relevant market is defined
- Imports as constraint on unilateral or coordinated effects by combined entity

Assessment of Import Factor

- Market share of imports (substantial if >10% for at least 3 years - Australia)
- Price at which imports become elastic
- Difference from import parity price
- Import duties & quota restrictions-present as well as likely
- Non-tariff trade barriers (standards)
- Transport costs
- Potential imports more important than actual imports



Availability of Substitutes (g)

- Supply side substitution- US: supplies from “uncommitted entrants” within 1 year without significant sunk costs of entry or exit in response to SSNIP
- CA, 2002-relevant product market definition considers only demand side substitution [2(t)]
- In US & EC market shares calculated based on supply side substitutability
- CA, 2002- as an assessment factor after market shares are determined

Supply Side Substitutability

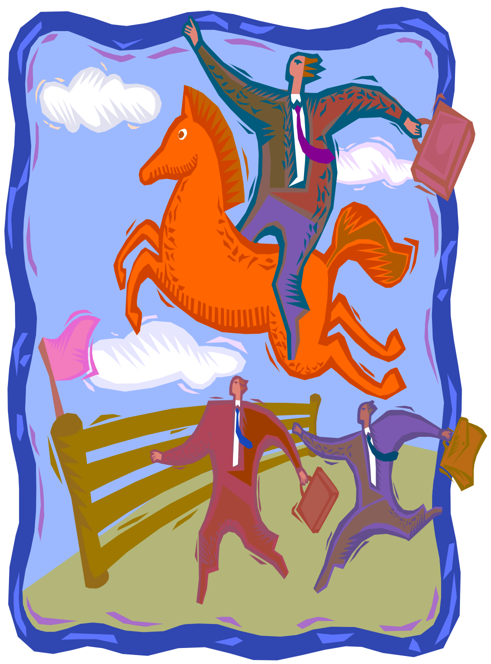
- Depends on technological ability, product acceptance and distribution facility
- Supplies by switching of existing assets to produce for relevant market
- Destabilizing factor for unilateral & coordinated effects
- Effects are similar to low barriers to expansion or easy entry

Extent of Barriers to Entry (b)

- Extent of barriers to entry in CA, 2002 but entry analysis is wider in US & EU
- Entry barriers - one aspect of entry analysis (related to likelihood of entry)
- Likely, timely & sufficiency of entry important to be considered as sufficient competitive constraint
- Entry considered so important in US that if entry is proved to be likely, timely & sufficient, requires no further competition analysis

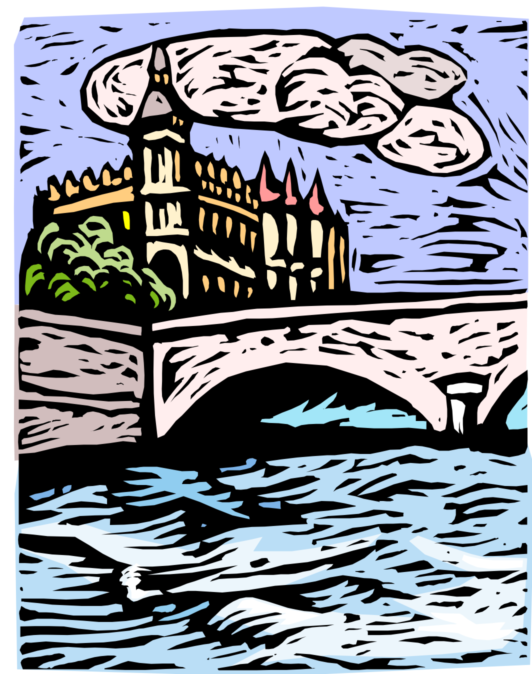
Entry Characteristics

- Likelihood of entry - profitable at pre-merger prices, minimum viable scale available, overcome any network effects, history of entry or exit
- Sufficiency of entry -introduction of close substitute which can neutralize output reduction in relevant market substantially, sufficient number of customers to switch in case of price rise
- Timeliness of entry - significant impact on prices within 2 years



Entry Barriers

- Illustrative list of barriers to entry given in section 19(4)(h) of CA,2002-regulatory barriers, financial risk, high capital cost, marketing, technical, economies of scale, high cost of substitutable goods or services
- Sunk costs-costs of tangible & intangible assets that cannot be recovered through redeployment of assets outside relevant market (US)-technology, marketing, R&D, regulatory approvals
- Possibility of predatory behaviour



Vertical Integration (j)

- Factor can be used both in relation to horizontal or vertical combination
- Concentration at one or more stages
- Vertical Independence of rivals from merged firm
- Similarity or diversity of degree of vertical integration determines stability of coordinated effects in horizontal mergers
- Different degrees of vertical integration hinder possibility of detecting deviations
- Difficult to converge on level of prices & production if asymmetric firms in market

Countervailing Power (d)

- Whether sufficient countervailing buyer power to neutralize market power of combined entity
- Buyer power- “bargaining strength vis-à-vis seller in commercial negotiations due to size, commercial significance to seller & ability to switch to alternative suppliers”-EC
- Ability of customer to sponsor upstream entry by committed orders
- Mitigating factor for unilateral or coordinated effects

Assessing Buyer Power

- Existence of viable alternatives or credible threats to switch
- Symmetry between buyer & supplier sides
- Share of smaller customers
- *Enso/Stora case* in EC-combined entity's share of liquid packaging board market would be 50-70% after merger but buyer Tetra Pak had sufficient buyer power
- Assessment with respect to price discrimination in small buyers' market

Removal of Competitor (i)

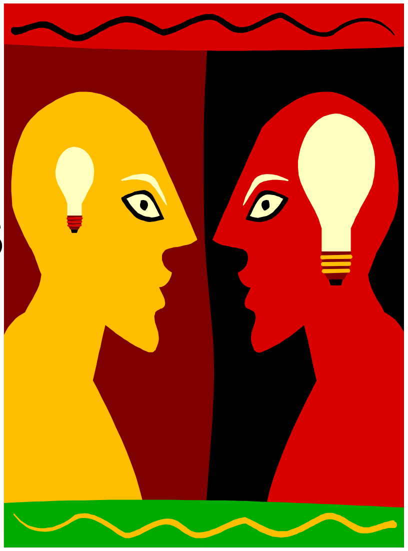
- CA, 2002- “likelihood that combination would result in removal of a vigorous & effective competitor(s) in the market”
- Factor in assessing unilateral & coordinated effects
- Combination with close or strong competitor (recent entrant/ innovator) will have unilateral effects
- Potential competitor considered (EC)
- Removal of “maverick” firm will have strong coordinated effects

Nature & Extent of Innovation (I)

- Nature of innovation affects nature of competition in the market
- Markets characterized by substantial product innovation are less prone to coordinated effects
- Lack of innovation is another feature of market conducive to oligopoly- EC
- Dominant innovator has advantages
- Extent of innovation-percentage of sales accounted for by products introduced in last 2-3 years

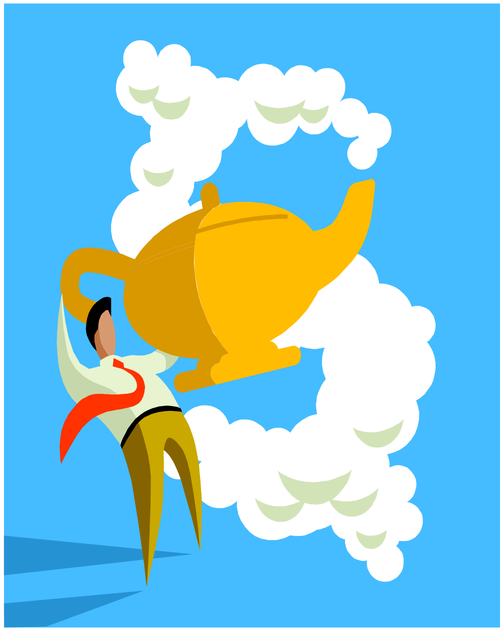
Innovation Market Concept

- Special characteristics-High R&D intensity and dependence on IPRs
- Increasing returns to scale & network effects- single firm dominance
- Significant compatibility & standards issues
- “Gatekeeper” power on terms of access to rivals
- First mover advantages & increased ability to exclude or restrict rivals
- Effect of combination on future innovations in market



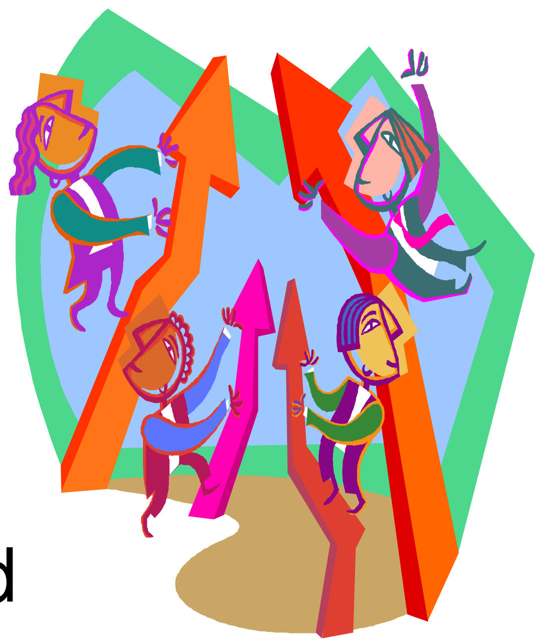
Benefits (Efficiencies) (n)

- Act-“Whether benefits of combination outweigh adverse impact of combination”
- Efficiency “defense” versus efficiency “offence” argument- “entrenchment”
- Efficiencies considered adversely in earlier US cases- *Proctor & Gamble*
- Paradigm shift -from efficiencies raising market power to ability to compete
- Prominence to efficiencies only as late as 1992(revised 1997) US & 2004 EC guidelines
- Convergence in both US & EC now



Efficiencies

- Should be substantial & timely
- Should benefit consumers- reductions be passed on & result in lower prices
- Should be Merger-specific
- “Cognizable efficiencies”- verifiable & net of costs (US)
- Higher adverse competitive effects – greater cognizable efficiencies required
- Efficiencies almost never justify merger-to-monopoly or near monopoly merger (US & EC)



Failing Business (k)

- Failure of firm- loss of rivalry
- Pre-merger competition not ensured even if merger blocked
- Comparison not with premerger situation but with failing firm exiting market (counterfactual)
- Case as if failing firm is the acquiring firm

Failing Firm Defense

- Such financial position that assets will otherwise exit
- No serious prospect of re-organizing business
- No less anticompetitive alternative to combination – no other credible bidders
- Parties to establish that assets would exit relevant market but for combination
- Financial distress alone - not enough evidence

Increase in Price or Profit (e)

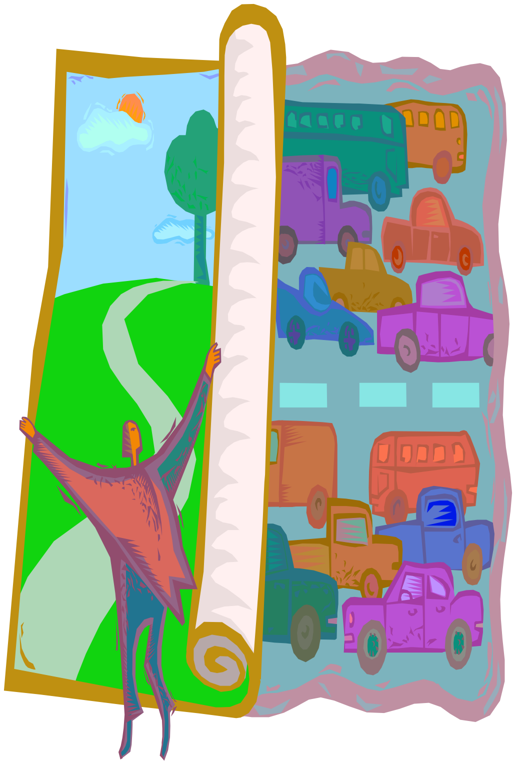
- CA, 2002- "likelihood that combination would result in parties being able to significantly & sustainably increase prices or profit margins"
- Closer to concept of unilateral effects
- Factors of unilateral effects to be seen for assessment
- Allows the Commission to bring in other relevant factors for assessment- e.g. ability to hinder expansion by competitors (EC)

Effective Competition (f)

- CA, 2002- “extent of effective competition likely to sustain in market”
- Closer to concept of coordinated effects
- Factors in coordinated effects to be seen for assessment
- Allows the Commission to bring in other relevant factors for assessing coordinated effects
- Examples-Structural features of market, past history of collusive behaviour, etc

Economic Development (m)

- Non-competition factor
- Effects on employment
- Restructuring - relocation of units
- Effects on FDI inflow
- Effect on particular industrial sector or region
- Export competitiveness
- Import substitution



Other Non-Competition Factors

- South Africa-"Public interest" includes effects on employment & industrial sector/region, ability of *small businesses*, or *firms* controlled or owned by historically disadvantaged persons to become competitive & ability of national industries to compe in international markets
- Australia- "Public benefits" include import replacement, international competitiveness, employment growth

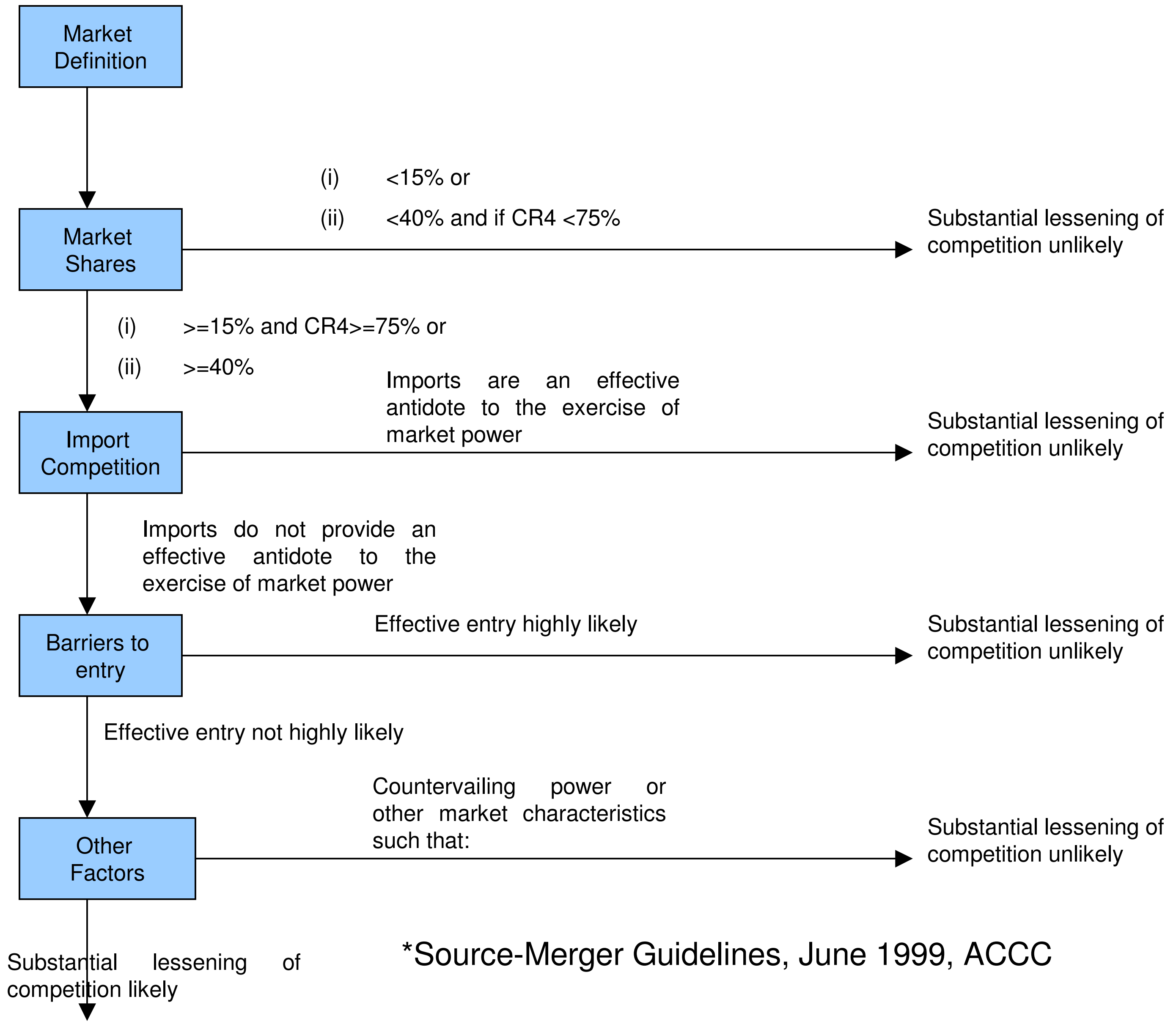
Convergence of Approaches

- ICN project on merger guidelines- comparative study discussed in conferences in Merida (2003), Seol (2004) & Cape Town (2006)
- Study concluded- few fundamental differences & great deal in common
- Published ICN merger guidelines workbook- April 2006
- Common approaches & best practices
- Provides analytical framework for competition assessment of mergers

Assessment Approach

- Analytical framework
- Factors for analysis
- Stage-by-stage approach
- Screening through filters
- Simple to complex cases
- Transparecy through guidelines

Flow Chart- Australia



*Source-Merger Guidelines, June 1999, ACCC

Key Elements Revisited

- Market share & concentration
  [(h)&(c)]
- Unilateral effects
  [(e),(d),(i)&(l)]
- Coordinated effects
  [(f),(d),(j),(i)&(l)]
- Market entry & expansion
  [(b),(a)&(g)]
- Efficiencies
  (n)
- Failing firm
  (k)

THANK YOU

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