MERGER GUIDELINES

COMPETITION COMMISSION OF PAKISTAN

Competition Commission of Pakistan
Guidelines on the Assessment of Horizontal Mergers
(Merger Guidelines 2008)

I
INTRODUCTION

1. These Guidelines are issued in pursuance of Regulation 28 of Competition (Merger Control) Regulations, 2007 (hereinafter referred to as the "CMC Regulations") and are only illustrative and not exhaustive and do not set a limit on the investigation and enforcement powers of the Commission. The objective of these Guidelines is to provide guidance as to how the Commission assesses horizontal mergers i.e. when the undertakings concerned are actual or potential competitors in the same relevant market. While these Guidelines present the analytical approach used by the Commission in its appraisal of horizontal mergers, it cannot provide details of all possible applications of this approach. The Commission applies the approach described in the Guidelines to the particular facts and circumstances of each case.

2. Section 11 of the Competition Ordinance 2007 (hereinafter the "Ordinance") provides that the Commission has to review intended mergers of the undertakings which meet the prescribed notification thresholds under the Competition (Merger Control) Regulations, 2007. The Commission upon review in the first phase shall by way of an Order decide whether such merger meets the threshold or presumption of dominance under the Ordinance. If dominance is so determined, the Commission shall initiate a second phase review to assess whether the merger shall substantially lessen competition by creating or strengthening a dominant position in the relevant market.

3. Accordingly, the Commission must take into account any significant impediment to effective competition likely to be caused by a merger. The creation or the strengthening of a dominant position is a primary form of such competitive harm. The concept of dominance has been defined in section 2(e) of the Ordinance as:

    (a) "dominant position" of one undertaking or several undertakings in a relevant market shall be deemed to exist if such undertaking or undertakings have the ability to behave to an appreciable extent independently of competitors, customers, consumers and suppliers and the position of an undertaking shall be presumed to be dominant if its share of the relevant market exceeds forty percent.

4. The creation or strengthening of a dominant position held by a single undertaking as a result of a merger has been the most common basis for finding that a merger would result in a significant impediment to effective competition. Furthermore, the concept

of dominance has also been applied in an oligopolistic setting to cases of collective dominance. As a consequence, it is expected that most cases of incompatibility of a merger with the relevant market will continue to be based upon a finding of dominance. That concept therefore provides an important indication as to the standard of competitive harm that is applicable when determining whether a merger is likely to substantially lessen competition, and hence, as to the likelihood of intervention.

5. The guidance set out in these Guidelines draws on the extensive experience of jurisdictions that have mature merger control regimes. The principles contained here will be applied and further developed and refined by the Commission from time to time in individual cases. The Commission may revise these Guidelines from time to time on the basis of its experience and in light of the developments that may take place in the future.

II
OVERVIEW

6. Effective competition brings benefits to consumers, such as low prices, high quality products, a wide selection of goods and services, and innovation. Through control of mergers, the Commission prevents mergers that would be likely to deprive customers of these benefits by significantly increasing the market power of undertakings. By 'increased market power' is meant the ability of one or more undertakings to profitably increase prices, reduce output, choice or quality of goods and services, diminish innovation, or otherwise influence parameters of competition. In these Guidelines the expression 'increased prices' is often used as shorthand for the various ways in which a merger may result in competitive harm. Both suppliers and buyers can have market power. However, for clarity, market power will usually refer here to a supplier's market power. Where a buyer's market power is the issue, the term 'buyer power' is employed.

7. In assessing the competitive effects of a merger, the Commission compares the competitive conditions that would result from the notified merger with the conditions that would have prevailed without the merger. In most cases, the competitive conditions existing at the time of the merger constitute the relevant comparison for evaluating the effects of a merger. However, in some circumstances, the Commission may take into account future changes to the market that can reasonably be predicted. It may, in particular, take account of the likely entry or exit of undertakings if the merger did not take place when considering what constitutes the relevant comparison.

8. The Commission's assessment of mergers normally entails:
    (a) definition of the relevant product and geographic markets;
    (b) competitive assessment of the merger.

The main purpose of market definition is to identify in a systematic way the immediate competitive constraints facing the merged entity. The term "relevant market" is defined in section 2(k) of the Ordinance. Various considerations leading to the delineation of the relevant markets may also be of importance for the competitive assessment of the merger.

9. These Guidelines are structured around the following factors:
   - (a) The approach of the Commission to market shares and concentration thresholds (Part III).
   - (b) The likelihood that a merger would have anticompetitive effects in the relevant markets, in the absence of countervailing factors (Part IV).
   - (c) increase in market power resulting from the merger (Part V).
   - (d) The likelihood that entry would maintain effective competition in the relevant markets (Part VI).
   - (e) The likelihood that efficiencies would act as a factor counteracting the harmful effects on competition which might otherwise result from the merger (Part VII).
   - (f) The conditions for a failing undertaking defence (Part VIII).

10. In order to assess the foreseeable impact of a merger on the relevant markets the Commission analyzes its possible anti-competitive effects and the relevant countervailing factors such as buyer power, the extent of entry barriers and possible efficiencies put forward by the parties. In exceptional circumstances, the Commission considers whether the conditions for a failing undertaking defence are met.

11. In the light of these elements, the Commission determines, pursuant to section 11 of the Ordinance, whether the merger would substantially lessen competition, in particular through the creation or the strengthening of a dominant position in the relevant market, and should, therefore, be blocked. It should be stressed that these factors are not a ‘checklist’ to be mechanically applied in each and every case. Rather, the competitive analysis in a particular case will be based on an overall assessment of the foreseeable impact of the merger in the light of the relevant factors and conditions. Not all the elements will always be relevant to each and every horizontal merger, and it may not be necessary to analyze all the elements of a case in the same detail.

III
MARKET SHARE AND CONCENTRATION LEVELS

12. Market shares and concentration levels provide useful first indications of the market structure and of the competitive importance of both the merging parties and their competitors.

13. Normally, the Commission uses current market shares in its competitive analysis. However, current market shares may be adjusted to reflect reasonably certain future changes, for instance in the light of exit, or expansion of existing market player or entry of new player. Post-merger market shares are calculated on the assumption that

the post-merger combined market share of the merging parties is the sum of their pre-merger market shares. Historical data may be used if market shares have been volatile, for instance when the market is characterized by large, lumpy orders. Changes in historic market shares may provide useful information about the competitive process and the likely future importance of the various competitors, for instance, by indicating whether undertakings have been gaining or losing market shares. In any event, the Commission interprets market shares in the light of likely market conditions; for instance, if the market is highly dynamic in character and if the market structure is unstable due to innovation or growth.

14. The overall concentration level in a market provides useful information about the competitive situation. In order to measure concentration levels, the Commission (often) may apply the Herfindahl-Hirschman Index. The Herfindahl-Hirschman Index or HHI is an indicator of the level of competition among the undertakings in the relevant market. An economic concept widely used by competition agencies to measure market concentration. The HHI is calculated by summing the squares of the individual market shares of all the undertakings in the market. As such, it can range from 0 to 10,000 moving from a large amount of small undertakings to a single monopolistic producer. Decreases in the Herfindahl index generally indicate a loss of market power/share and an increase in competition, whereas increases imply the opposite.

For example, if there are six undertakings in a market X with shares as follows:

A: 50%   B: 18%   C: 13%   D:10% E:5% F:4%

The HHI will be calculated as follows:

$(50)^2 + (18)^2 + (13)^2 + (10)^2 + (5)^2 + (4)^2$
2500 + 324 +169 +100 +25 +16 = **3134**

15. The HHI gives proportionately greater weight to the market shares of the larger undertakings. Although it is best to include all undertakings in the calculation, lack of information about very small undertakings may not be important because such undertakings do not affect the HHI significantly. While the absolute level of the HHI can give an initial indication of the competitive pressure in the market post-merger, the change in the HHI (known as the 'delta') is a useful proxy for the change in concentration directly brought about by the merger. The concentration of a market is categorized as follows:

   a. Unconcentrated markets where the HHI is less than 1000'
   b. Moderately concentrated markets where the HHI is between 1000 and 2000; and
   c. Highly concentrated markets where HHI exceeds 2000.

1. Market share

16. According to well-established global practices, large market shares — 40 % or more — may in themselves be evidence of the existence of a dominant market position. However, smaller competitors may act as a sufficient constraining influence if, for example, they have the ability and incentive to increase their supplies. A merger involving an undertaking whose market share will remain below 40 % after the merger may also raise competition concerns in view of other factors such as the strength and number of competitors, the presence of capacity constraints or the extent to which the products of the merging parties are close substitutes. The Commission may consider mergers resulting in undertakings holding market shares even below 40%, to lead to the creation or the strengthening of a dominant position.

17. Mergers which, by reason of the limited market share of the undertakings concerned, are not liable to substantially lessen competition may be presumed to be cleared by the Commission. Clearance is neither less mandatory if notification thresholds are met.

2. HHI levels

18. The Commission is unlikely to identify horizontal competition concerns in a market with a post-merger HHI below 1 000. Such markets normally do not require extensive analysis.

19. The Commission is also unlikely to identify horizontal competition concerns in a merger with a post-merger HHI between 1 000 and 2 000 and a delta below 250, or a merger with a post-merger HHI above 2 000 and a delta below 150, except where special circumstances such as, for instance, one or more of the following factors are present:
    - (a) a merger involves a potential entrant or a recent entrant with a small market share;
    - (b) one or more merging parties are important innovators in ways not reflected in market shares;
    - (c) there are significant cross-shareholdings among the market participants;
    - (d) one of the merging undertakings is a maverick undertaking with a high likelihood of disrupting coordinated conduct;
    - (e) indications of past or ongoing coordination, or facilitating practices, are present; and
    - (f) one of the merging parties has a pre-merger market share of 50 % or more.

20. Each of these HHI levels, in combination with the relevant deltas, may be used as an initial indicator of the absence of competition concerns. However, they do not give rise to a presumption of either the existence or the absence of such concerns.

IV
POSSIBLE ANTI-COMPETITIVE EFFECTS OF HORIZONTAL MERGERS

21. There are two main ways in which horizontal mergers may substantially lessen competition, in particular by creating or strengthening a dominant position:
    (a) by eliminating important competitive constraints on one or more undertakings, which consequently would have increased market power, without resorting to coordinated behaviour (non-coordinated effects); or

    (b) by changing the nature of competition in such a way that undertakings that previously were not coordinating their behaviour, are now significantly more likely to coordinate and raise prices or otherwise harm effective competition. A merger may also make coordination easier, more stable or more effective for undertakings which were coordinating prior to the merger (coordinated effects).

22. The Commission assesses whether the changes brought about by the merger would result in any of these effects. Both instances mentioned above may be relevant when assessing a particular transaction.

1. Non-coordinated effects

23. A merger may substantially lessen competition in a market by removing important competitive constraints on one or more sellers, who consequently have increased market power. The most direct effect of the merger will be the loss of competition between the merging undertakings. For example, if prior to the merger one of the merging undertakings had raised its price, it would have lost some sales to the other merging undertaking. The merger removes this particular constraint. Non-merging undertakings in the same market can also benefit from the reduction of competitive pressure that results from the merger, since the merging undertakings' price increase may switch some demand to the rival undertakings, which, in turn, may find it profitable to increase their prices. The reduction in these competitive constraints could lead to significant price increases in the relevant market.

24. Generally, a merger giving rise to such non-coordinated effects which would substantially lessen competition by creating or strengthening the dominant position of a single undertaking, one which, typically, would have an appreciably larger market share than the next competitor post-merger. Furthermore, mergers in oligopolistic

markets involving the elimination of important competitive constraints that the merging parties previously exerted upon each other together with a reduction of competitive pressure on the remaining competitors may, even where there is little likelihood of coordination between the members of the oligopoly, also result in a significant impediment to competition. Section 11 of the Ordinance prohibits all mergers giving rise to such non-coordinated effects.

25. A number of factors, which taken separately are not necessarily decisive, may influence whether significant non-coordinated effects are likely to result from a merger. Not all of these factors need to be present for such effects to be likely. Nor should be the following considered an exhaustive list.

(i) Merging undertakings have large market shares

26. The larger the market share, the more likely an undertaking is to possess market power. And the larger the addition of market share, the more likely it is that a merger will lead to a significant increase in market power. The larger the increase in the sales base on which to enjoy higher margins after a price increase, the more likely it is that the merging undertakings will find such a price increase profitable despite the accompanying reduction in output. Although market shares and additions of market shares only provide first indications of market power and increases in market power, they are normally important factors in the assessment.

(ii) Merging undertakings are close competitors

27. Products may be differentiated within a relevant market such that some products are closer substitutes than others. <u>The higher the degree of substitutability between the merging undertakings' products, the more likely it is that the merging undertakings will raise prices significantly</u>. For example, a merger between two producers offering products which a substantial number of customers regard as their first and second choices could generate a significant price increase. Thus, the fact that rivalry between the parties has been an important source of competition on the market may be a central factor in the analysis. High pre-merger margins may also make significant price increases more likely. The merging undertakings’ incentive to raise prices is more likely to be constrained when rival undertakings produce close substitutes to the products of the merging undertakings than when they offer less close substitutes. It is therefore less likely that a merger will substantially lessen competition, in particular through the creation or strengthening of a dominant position, when there is a high degree of substitutability between the products of the merging undertakings and those supplied by rival producers.

28. When data are available, the degree of substitutability may be evaluated through customer preference surveys, analysis of purchasing patterns, estimation of the cross-price elasticities of the products involved, or diversion ratios. In bidding markets it

may be possible to measure whether historically the submitted bids by one of the merging parties have been constrained by the presence of the other merging party.

29. In some markets it may be relatively easy and not too costly for the active undertakings to reposition their products or extend their product portfolio. In particular, the Commission examines whether the possibility of repositioning or product line extension by competitors or the merging parties may influence the incentive of the merged entity to raise prices. However, product repositioning or product line extension often entails risks and large sunk costs and may be less profitable than the current line.

(iii) Customers have limited possibilities of switching supplier

30. Customers of the merging parties may have difficulties switching to other suppliers because there are few alternative suppliers or because they face substantial switching costs. Such customers are particularly vulnerable to price increases. The merger may affect these customers' ability to protect themselves against price increases. In particular, this may be the case for customers that have used dual sourcing from the two merging undertakings as a means of obtaining competitive prices. Evidence of past customer switching patterns and reactions to price changes may provide important information in this respect.

(iv) Competitors are unlikely to increase supply if prices increase

31. When market conditions are such that the competitors of the merging parties are unlikely to increase their supply substantially if prices increase, the merging undertakings may have an incentive to reduce output below the combined pre-merger levels, thereby raising market prices. The merger increases the incentive to reduce output by giving the merged undertaking a larger base of sales on which to enjoy the higher margins resulting from an increase in prices induced by the output reduction.

32. Conversely, when market conditions are such that rival undertakings have enough capacity and find it profitable to expand output sufficiently, the Commission is unlikely to find that the merger will create or strengthen a dominant position or otherwise substantially lessen competition.

33. Such output expansion is, in particular, unlikely when competitors face binding capacity constraints and the expansion of capacity is costly or if existing excess capacity is significantly more costly to operate than capacity currently in use.

34. Although capacity constraints are more likely to be important when goods are relatively homogeneous, they may also be important where undertakings offer differentiated products.

(v) Merged entity able to hinder expansion by competitors

35. Some proposed mergers would, if allowed to proceed, substantially lessen competition by leaving the merged undertaking in a position where it would have the ability and incentive to make the expansion of smaller undertakings and potential competitors more difficult or otherwise restrict the ability of rival undertakings to compete. In such a case, competitors may not, either individually or in the aggregate, be in a position to constrain the merged entity to such a degree that it would not increase prices or take other actions detrimental to competition. For instance, the merged entity may have such a degree of control, or influence over, the supply of inputs or distribution possibilities that expansion or entry by rival undertakings may be more costly. Similarly, the merged entity's control over patents or other types of intellectual property (e.g. brands) may make expansion or entry by rivals more difficult. In markets where interoperability between different infrastructures or platforms is important, a merger may give the merged entity the ability and incentive to raise the costs or decrease the quality of service of its rivals. In making this assessment the Commission may take into account, *inter alia*, the financial strength of the merged entity relative to its rivals.

(vi) Merger eliminates an important competitive force

36. Some undertakings have more of an influence on the competitive process than their market shares or similar measures would suggest. A merger involving such a undertaking may change the competitive dynamics in a significant, anticompetitive way, in particular when the market is already concentrated. For instance, a undertaking may be a recent entrant that is expected to exert significant competitive pressure in the future on the other undertakings in the market.

37. In markets where innovation is an important competitive force, a merger may increase the undertakings' ability and incentive to bring new innovations to the market and, thereby, the competitive pressure on rivals to innovate in that market. Alternatively, effective competition may be significantly impeded by a merger between two important innovators, for instance, between two companies with ‘pipeline’ products related to a specific product market. Similarly, an undertaking with a relatively small market share may nevertheless be an important competitive force, if it has promising pipeline products.

2. Coordinated effects

38. In some markets the structure may be such that undertakings would consider it possible, economically rational, and hence preferable, to adopt on a sustainable basis, a course of action on the market aimed at selling at increased prices. A merger in a concentrated market may substantially lessen competition, through the creation or the

strengthening of a collective dominant position, because it increases the likelihood that undertakings are able to coordinate their behaviour in this way and raise prices, even without entering into an agreement or resorting to a concerted practice within the meaning of section 4 of the Ordinance. A merger may also make coordination easier, more stable or more effective for undertakings that were already coordinating before the merger, either by making the coordination more robust or by permitting undertakings to coordinate on even higher prices.

39. Coordination may take various forms. In some markets, the most likely coordination may involve keeping prices above the competitive level. In other markets, coordination may aim at limiting production or the amount of new capacity brought to the market. Undertakings may also coordinate by dividing the market, for instance, by geographic area or other customer characteristics, or by allocating contracts in bidding markets.

40. Coordination is more likely to emerge in markets where it is relatively simple to reach a common understanding on the terms of coordination. In addition, three conditions are necessary for coordination to be sustainable. First, the coordinating undertakings must be able to monitor to a sufficient degree whether the terms of coordination are being adhered to. Second, discipline requires that there is some form of credible deterrent mechanism that can be activated if deviation is detected. Third, the reactions of outsiders, such as current and future competitors not participating in the coordination, as well as customers, should not be able to jeopardize the results expected from the coordination.

41. The Commission examines whether it would be possible to reach terms of coordination and whether the coordination is likely to be sustainable. In this respect, the Commission considers the changes that the merger brings about. The reduction in the number of undertakings in a market may, in itself, be a factor that facilitates coordination. However, a merger may also increase the likelihood or significance of coordinated effects in other ways. For instance, a merger may involve a 'maverick' undertaking that has a history of preventing or disrupting coordination, for example by failing to follow price increases by its competitors, or has characteristics that gives it an incentive to favour different strategic choices than its coordinating competitors would prefer. If the merged undertaking were to adopt strategies similar to those of other competitors, the remaining undertakings would find it easier to coordinate, and the merger would increase the likelihood, stability or effectiveness of coordination.

42. In assessing the likelihood of coordinated effects, the Commission takes into account all available relevant information on the characteristics of the markets concerned, including both structural features and the past behaviour of undertakings. Evidence of past coordination is important if the relevant market characteristics have not changed appreciably or are not likely to do so in the near future. Likewise, evidence of coordination in similar markets may be useful information.

(i) Deterrent mechanisms

43. Coordination is not sustainable unless the consequences of deviation are sufficiently severe to convince coordinating undertakings that it is in their best interest to adhere to the terms of coordination. It is thus the threat of future retaliation that keeps the coordination sustainable. However the threat is only credible if, where deviation by one of the undertakings is detected, there is sufficient certainty that some deterrent mechanism will be activated.

44. Retaliation that manifests itself after some significant time lag, or is not certain to be activated, is less likely to be sufficient to offset the benefits from deviating. For example, if a market is characterized by infrequent, large volume orders, it may be difficult to establish a sufficiently severe deterrent mechanism. The reason being that the gain from deviating at the right time may be large, certain and immediate, whereas the losses from being punished may be small and uncertain and only materialize after some time. The speed with which deterrent mechanisms can be implemented is related to the issue of transparency. If undertakings are only able to observe their competitors' actions after a substantial delay, then retaliation will be similarly delayed and this may influence whether it is sufficient to deter deviation.

45. The credibility of the deterrence mechanism depends on whether the other coordinating undertakings have an incentive to retaliate. Some deterrent mechanisms, such as punishing the deviator by temporarily engaging in a price war or increasing output significantly, may entail a short-term economic loss for the undertakings carrying out the retaliation. This does not necessarily remove the incentive to retaliate since the short-term loss may be smaller than the long-term benefit of retaliating resulting from the return to the regime of coordination.

46. Retaliation need not necessarily take place in the relevant market as the deviation. If the coordinating undertakings have commercial interaction in other markets, these may offer various methods of retaliation. The retaliation could take many forms, including cancellation of joint ventures or other forms of cooperation or selling of shares in jointly owned companies.

(ii) Reactions of outsiders

47. For coordination to be successful, the actions of non-coordinating undertakings and potential competitors, as well as customers, should not be able to jeopardize the outcome expected from coordination. For example, if coordination aims at reducing overall capacity in the market, this will only hurt consumers if non-coordinating undertakings are unable or have no incentive to respond to this decrease by increasing their own capacity sufficiently to prevent a net decrease in capacity, or at least to render the coordinated capacity decrease unprofitable.

48. The effects of entry and countervailing buyer power of customers are analyzed in later parts. However, special consideration is given to the possible impact of these elements on the stability of coordination. For instance, by concentrating a large

amount of its requirements with one supplier or by offering long-term contracts, a large buyer may make coordination unstable by successfully tempting one of the coordinating undertakings to deviate in order to gain substantial new business.

(iii) Merger with a potential competitor

49. Mergers where an undertaking already active on a relevant market merges with a *potential competitor* in this market can have similar anti-competitive effects to mergers between two undertakings already active on the same relevant market and, thus, substantially lessens competition, in particular through the creation or the strengthening of a dominant position.

50. A merger with a potential competitor can generate horizontal anti-competitive effects, whether coordinated or non-coordinated, if the potential competitor significantly constrains the behaviour of the undertakings active in the market. This is the case if the potential competitor possesses assets that could easily be used to enter the market without incurring significant sunk costs. Anti-competitive effects may also occur where the merging partner is very likely to incur the necessary sunk costs to enter the market in a relatively short period of time after which the merged entity would constrain the behaviour of the undertakings currently active in the market.

51. For a merger with a potential competitor to have significant anti-competitive effects, two basic conditions must be fulfilled. First, the potential competitor must already exert a significant constraining influence or there must be a significant likelihood that it would grow into an effective competitive force. Evidence that a potential competitor has plans to enter a market in a significant way could help the Commission to reach such a conclusion. Second, there must not be a sufficient number of other potential competitors, which could maintain sufficient competitive pressure after the merger.

(iv) Mergers creating or strengthening buyer power in upstream markets

52. The Commission may also analyse to what extent a merged entity will increase its buyer power in upstream markets. On the one hand, a merger that creates or strengthens the market power of a buyer may substantially lessen competition, in particular by creating or strengthening a dominant position. The merged undertaking may be in a position to obtain lower prices by reducing its purchase of inputs. This may, in turn, lead it also to lower its level of output in the final product market, and thus harm consumer welfare. Such effects may in particular arise when upstream sellers are relatively fragmented. Competition in the downstream markets could also be adversely affected if, in particular, the merged entity were likely to use its buyer power vis-à-vis its suppliers to foreclose its rivals.

53. On the other hand, increased buyer power may be beneficial for competition. If increased buyer power lowers input costs without restricting downstream competition or total output, then a proportion of these cost reductions are likely to be passed onto consumers in the form of lower prices.

54. In order to assess whether a merger would substantially lessen competition by creating or strengthening buyer power, an analysis of the competitive conditions in upstream markets and an evaluation of the possible positive and negative effects described above are, therefore, required.

V
COUNTERVAILING BUYER POWER

55. The competitive pressure on a supplier is not only exercised by competitors but can also come from its customers. Even undertakings with very high market shares may not be in a position, post-merger, to substantially lessen competition, in particular, by acting to an appreciable extent independently of their customers, if the latter possess countervailing buyer power. Countervailing buyer power in this context should be understood as the bargaining strength that the buyer has vis-à-vis the seller in commercial negotiations due to its size, its commercial significance to the seller and its ability to switch to alternative suppliers.

56. The Commission considers, when relevant, to what extent customers will be in a position to counter the increase in market power that a merger would otherwise be likely to create. One source of countervailing buyer power would be if a customer could credibly threaten to resort, within a reasonable timeframe, to alternative sources of supply should the supplier decide to increase prices or to otherwise deteriorate quality or the conditions of delivery. This would be the case if the buyer could immediately switch to other suppliers, credibly threaten to vertically integrate into the upstream market or to sponsor upstream expansion or entry, for instance, by persuading a potential entrant to enter by committing to placing large orders with this company. It is more likely that large and sophisticated customers will possess this kind of countervailing buyer power than smaller undertakings in a fragmented industry. A buyer may also exercise countervailing buying power by refusing to buy other products produced by the supplier or, particularly in the case of durable goods, delaying purchases.

57. In some cases, it may be important to pay particular attention to the incentives of buyers to utilise their buyer power. For example, a downstream undertaking may not wish to make an investment in sponsoring new entry if the benefits of such entry in terms of lower input costs could also be reaped by its competitors.

58. Countervailing buyer power cannot be found to sufficiently off-set potential adverse effects of a merger if it only ensures that a particular segment of customers, with particular bargaining strength, is shielded from significantly higher prices or deteriorated conditions after the merger. Furthermore, it is not sufficient that buyer

power exists prior to the merger; it must also exist and remain effective following the merger. This is because a merger of two suppliers may reduce buyer power if it thereby removes a credible alternative.

VI
ENTRY

59. When entering a market is sufficiently easy, a merger is unlikely to pose any significant anti-competitive risk. Therefore, entry analysis constitutes an important element of the overall competitive assessment. For entry to be considered a sufficient competitive constraint on the merging parties, it must be shown to be likely, timely and sufficient to deter or defeat any potential anti-competitive effects of the merger.

1. Likelihood of entry

60. The Commission examines whether entry is likely or whether potential entry is likely to constrain the behaviour of incumbents post-merger. For entry to be likely, it must be sufficiently profitable taking into account the price effects of injecting additional output into the market and the potential responses of the incumbents. Entry is thus less likely if it would only be economically viable on a large scale, thereby resulting in significantly depressed price levels. And entry is likely to be more difficult if the incumbents are able to protect their market shares by offering long-term contracts or giving targeted pre-emptive price reductions to those customers that the entrant is trying to acquire. Furthermore, high risk and costs of failed entry may make entry less likely. The costs of failed entry will be higher, the higher is the level of sunk cost associated with entry.

61. Potential entrants may encounter barriers to entry which determine entry risks and costs and thus have an impact on the profitability of entry. Barriers to entry are specific features of the market, which give incumbent undertakings advantages over potential competitors. When entry barriers are low, the merging parties are more likely to be constrained by entry. Conversely, when entry barriers are high, price increases by the merging undertakings would not be significantly constrained by entry. Historical examples of entry and exit in the industry may provide useful information about the size of entry barriers.

62. Barriers to entry can take various forms:

    (a) Legal advantages encompass situations where regulatory barriers limit the number of market participants by, for example, restricting the number of licences. They also cover tariff and non-tariff trade barriers.

    (b) The incumbents may also enjoy technical advantages, such as preferential access to essential facilities, natural resources, innovation and R & D, or intellectual property rights, which make it difficult for any undertaking to compete successfully. For instance, in certain industries, it might be difficult to obtain essential input materials, or patents might protect products or processes. Other factors such as economies of scale and scope, distribution and sales networks, access to important technologies, may also constitute barriers to entry.

(c) Furthermore, barriers to entry may also exist because of the established position of the incumbent undertakings on the market. In particular, it may be difficult to enter a particular industry because experience or reputation is necessary to compete effectively, both of which may be difficult to obtain as an entrant. Factors such as consumer loyalty to a particular brand, the closeness of relationships between suppliers and customers, the importance of promotion or advertising, or other advantages relating to reputation will be taken into account in this context. Barriers to entry also encompass situations where the incumbents have already committed to building large excess capacity, or where the costs faced by customers in switching to a new supplier may inhibit entry.

63. The expected evolution of the market should be taken into account when assessing whether or not entry would be profitable. Entry is more likely to be profitable in a market that is expected to experience high growth in the future than in a market that is mature or expected to decline. Scale economies or network effects may make entry unprofitable unless the entrant can obtain a sufficiently large market share.

64. Entry is particularly likely if suppliers in other markets already possess production facilities that could be used to enter the market in question, thus reducing the sunk costs of entry. The smaller the difference in profitability between entry and non-entry prior to the merger, the more likely such a reallocation of production facilities.

2. Timeliness

65. The Commission examines whether entry would be sufficiently swift and sustained to deter or defeat the exercise of market power. What constitutes an appropriate time period depends on the characteristics and dynamics of the market, as well as on the specific capabilities of potential entrants. However, entry is normally only considered timely if it occurs within two years.

3. Sufficiency

66. Entry must be of sufficient scope and magnitude to deter or defeat the anti-competitive effects of the merger. Small-scale entry, for instance into some market 'niche', may not be considered sufficient.

VII
EFFICIENCIES

67. Corporate re-organizations in the form of mergers may be in line with the requirements of dynamic competition and are capable of increasing the competitiveness of industry, thereby improving the conditions of growth and raising the standards of living. It is possible that efficiencies brought about by a merger counteract the effects on competition and in particular the potential harm to consumers that it might otherwise have. In order to assess whether a merger would substantially lessen competition, in particular through the creation or the strengthening of a dominant position, the Commission performs an overall competitive appraisal of the merger. In making this appraisal, the Commission takes into account the factors mentioned in section 11(10) of the Ordinance; provided that it is to the consumers' advantage and does not form an obstacle to competition.

68. The Commission considers any substantiated efficiency claim in the overall assessment of the merger. It may decide that, as a consequence of the efficiencies that the merger brings about, there are no grounds for blocking the merger. This will be the case when the Commission is in a position to conclude on the basis of sufficient evidence that the efficiencies generated by the merger are likely to enhance the ability and incentive of the merged entity to act pro-competitively for the benefit of consumers, thereby counteracting the adverse effects on competition which the merger might otherwise have.

69. For the Commission to take account of efficiency claims in its assessment of the merger and be in a position to reach the conclusion that as a consequence of efficiencies, there are no grounds for blocking the merger, the efficiencies have to benefit consumers, be merger-specific and be verifiable. These conditions are cumulative.

1. Benefit to consumers

70. The relevant benchmark in assessing efficiency claims is that consumers will not be worse off as a result of the merger. For that purpose, efficiencies should be substantial and timely, and should, in principle, benefit consumers in those relevant markets where it is otherwise likely that competition concerns would occur.

71. Mergers may bring about various types of efficiency gains that can lead to lower prices or other benefits to consumers. For example, cost savings in production or distribution may give the merged entity the ability and incentive to charge lower prices following the merger. In line with the need to ascertain whether efficiencies will lead to a net benefit to consumers, cost efficiencies that lead to reductions in variable or marginal costs are more likely to be relevant to the assessment of efficiencies than reductions in fixed costs; the former are, in principle, more likely to result in lower prices for consumers. Cost reductions, which merely result from anti-competitive reductions in output, cannot be considered as efficiencies benefiting consumers.

72. Consumers may also benefit from new or improved products or services, for instance resulting from efficiency gains in the sphere of R & D and innovation. A joint venture

company set up in order to develop a new product may bring about the type of efficiencies that the Commission can take into account.

73. In the context of coordinated effects, efficiencies may increase the merged entity's incentive to increase production and reduce prices, and thereby reduce its incentive to coordinate its market behaviour with other undertakings in the market. Efficiencies may therefore lead to a lower risk of coordinated effects in the relevant market.

74. In general, the later the efficiencies are expected to materialize in the future, the less weight the Commission can assign to them. This implies that, in order to be considered as a counteracting factor, the efficiencies must be timely.

75. The incentive on the part of the merged entity to pass efficiency gains on to consumers is often related to the existence of competitive pressure from the remaining undertakings in the market and from potential entry. The greater the possible negative effects on competition, the more the Commission has to be sure that the claimed efficiencies are substantial, likely to be realized, and to be passed on, to a sufficient degree, to the consumer. It is highly unlikely that a merger leading to a market position approaching that of a monopoly, or leading to a similar level of market power, can be declared compatible with the common market on the ground that efficiency gains would be sufficient to counteract its potential anti-competitive effects.

2. Merger specificity

76. Efficiencies are relevant to the competitive assessment when they are a direct consequence of the notified merger and cannot be achieved to a similar extent by less anticompetitive alternatives. In these circumstances, the efficiencies are deemed to be caused by the merger and thus, merger-specific. It is for the merging parties to provide in due time all the relevant information necessary to demonstrate that there are no less anticompetitive, realistic and attainable alternatives of a non-concentrative nature (e.g. a licensing agreement, or a cooperative joint venture) or of a concentrative nature (e.g. a concentrative joint venture, or a differently structured merger) than the notified merger which preserve the claimed efficiencies. The Commission considers only the alternatives that are reasonably practical in the business situation faced by the merging parties having regard to established business practices in the industry concerned.

3. Verifiability

77. Efficiencies have to be verifiable such that the Commission can be reasonably certain that the efficiencies are likely to materialize, and be substantial enough to counteract a merger's potential harm to consumers. The more precise and convincing the efficiency claims are, the better the Commission can evaluate the claims. Where reasonably possible, efficiencies and the resulting benefit to consumers should therefore be quantified. When the necessary data are not available to allow for a

precise quantitative analysis, it must be possible to foresee a clearly identifiable positive impact on consumers, not a marginal one. In general, the longer the start of the efficiencies is projected into the future, the less probability the Commission may be able to assign to the efficiencies actually being brought about.

78. Most of the information, allowing the Commission to assess whether the merger will bring about the sort of efficiencies that would enable it to clear a merger, is solely in the possession of the merging parties. It is, therefore, incumbent upon the notifying parties to provide in due time all the relevant information necessary to demonstrate that the claimed efficiencies are merger-specific and likely to be realized. Similarly, it is for the notifying parties to show to what extent the efficiencies are likely to counteract any adverse effects on competition that might otherwise result from the merger, and therefore benefit consumers.

79. Evidence relevant to the assessment of efficiency claims includes, in particular, internal documents that were used by the management to decide on the merger, statements from the management to the owners and financial markets about the expected efficiencies, historical examples of efficiencies and consumer benefit, and pre-merger external experts' studies on the type and size of efficiency gains, and on the extent to which consumers are likely to benefit.

VIII
FAILING UNDERTAKING

80. The Commission may decide that an otherwise problematic merger be cleared if one of the merging parties is a failing undertaking. The basic requirement is that the deterioration of the competitive structure that follows the merger cannot be said to be caused by the merger. This will arise where the competitive structure of the market would deteriorate to at least the same extent in the absence of the merger.

81. The Commission considers the following three criteria to be especially relevant for the application of a ‘failing undertaking defence’. First, the allegedly failing undertaking would in the near future be forced out of the market because of financial difficulties if not taken over by another undertaking. Second, there is no less anti-competitive alternative purchaser than the notified acquirer. Third, in the absence of a merger, the assets of the failing undertaking would inevitably exit the market.

82. It is for the notifying parties to provide in due time all the relevant information necessary to demonstrate that the deterioration of the competitive structure that follows the merger is not caused by the merger.