Organisation for Economic Co-operation and Development

DAF/COMP/GF/WD(2020)47

Unclassified | English - Or. English

16 November 2020

DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS
COMPETITION COMMITTEE

Global Forum on Competition

ECONOMIC ANALYSIS IN MERGER INVESTIGATIONS – Contribution from Business at OECD

- Session III -

9 December 2020

This contribution is submitted by Business at OECD under Session III of the Global Forum on Competition to be held on 7-10 December 2020.

More documentation related to this discussion can be found at: oe.cd/mergerinv.

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JT03468518

Economic Analysis in Merger Investigations

- Contribution from Business at OECD –

1. Introduction

1. *Business at OECD* appreciates the opportunity to submit these comments to the OECD Global Forum on Competition for the sessions on economic analysis in merger investigations. The importance and role of economics in merger control is an area of key concern to the business community. *Business at OECD* has submitted numerous comments on this topic in the past as part of its submissions on specific merger control topics.[1]

2. To ensure effective merger enforcement, it is generally recognized that it is not a question of whether competition authorities should utilize economic analysis in merger enforcement but *how* economic analysis is used. Including modern economic principles into competition agency analysis and decision-making that are well recognized and empirically tested can result in better decision-making. But there is also the potential for economic analysis itself to be misused in developing an erroneous theory of harm. A challenge for agencies in ensuring effective enforcement is to adapt analytic techniques that accurately distinguish anti- from pro-competitive practices into administrable rules.[2] Those rules also have to be stable and predictable to allow business to effectively rely on them.

3. Economics generally provides competition agencies with the conceptual framework and tools upon which to base administrable rules to assess the potential anticompetitive effects of mergers. Within the merger control context, the three primary uses of economics are: (i) understanding how the market functions, (ii) developing a theory (or theories) of harm, and (iii) use of relevant evidence to support applicable theories of harm and to better understand the effects of a merger.[3] Economics also can provide a range of tools that can be used to empirically estimate the effects of mergers. But the type and level of analysis that can be performed largely depends on the amount and quality of empirical evidence.[4]

4. In its previous comments, *Business at OECD* has stressed the importance of competition and merger control that relies on well-established economic initiatives and

[1] *See* OECD, THE ROLE AND MEASUREMENT OF QUALITY IN COMPETITION ANALYSIS 127-144 (2013), *available at* http://www.oecd.org/competition/Quality-in-competition-analysis-2013.pdf; OECD, Non-Price Effects of Mergers—Note by BIAC, DAF/COMP/WD(2018)71 (May 28, 2018), *available at* https://one.oecd.org/document/DAF/COMP/WD(2018)71/en/pdf; OECD, Merger Control in Dynamic Markets—Contribution by BIAC, DAF/COMP/GF/WD(2019)41 (Nov. 20, 2019), *available at* https://one.oecd.org/document/DAF/COMP/GF/WD(2019)41/en/pdf; OECD, Vertical Mergers in the Technology, Media and Telecom Sector—Note by BIAC, DAF/COMP/WD(2019)73 (June 4, 2019), *available at* https://one.oecd.org/document/DAF/COMP/WD(2019)73/en/pdf; OECD, Conglomerate Effects of Mergers—Note by BIAC, DAF/COMP/WD(2020)12 (May 28, 2020), *available at* https://one.oecd.org/document/DAF/COMP/WD(2020)12/en/pdf.

[2] William E. Kovacic & Carl Shapiro, *Antitrust Policy: A Century of Economic and Legal Thinking*, 14 J. ECON. PERS. 43-60 (2000).

[3] INT'L COMPETITION NETWORK, THE ROLE OF ECONOMISTS AND ECONOMIC EVIDENCE IN MERGER ANALYSIS (2013), *available at* https://www.internationalcompetitionnetwork.org/wp-content/uploads/2018/05/MWG_RoleofEconomics.pdf. This could include assessing the likely procompetitive benefits of a merger, including cost-based efficiencies and increases in quality, innovation or service.

[4] *Id.*

analytical tools. Those comments also emphasized that this is important to consumers and the business community alike as it promotes predictability and legal certainty in merger review thereby reducing the risk of both type 1 (false positives) and type 2 (false negatives) errors. This is not to suggest that analytical tools and economic analysis in merger control should not be modified or tailored to specific circumstances. Economically sound and targeted analysis can assist competition authorities to avoid both under and over intervention and produce outcomes that best serve the whole community.

5. Most competition authorities rely on a more "form-based" approach to merger review that regulates competition according to prescribed rules that define acceptable and unacceptable forms of firm behavior and market structure (e.g., market share tests).[5] This has the advantage of promoting predictability and legal certainty for the merging parties and the broader business community. With the increased use of economic analysis, many competition authorities apply an "effects-based" approach that focuses more on the effect of specific market structures on consumers. This effects-based competition enforcement may come at the cost of the legal certainty provided by the forms-based approach that allows firms to immediately assess the risks of merger enforcement.

6. *Business at OECD* has previously highlighted this inherent tension between a form-based and effects-based approach and suggested general principles to retain the benefits of predictability and legal certainty while still ensuring effective competition enforcement. These general principles are contained in *Business at OECD*'s previous submission on the use of economic evidence in merger analysis, as follows:

- [A]void techniques that increase the prospect of type I and type II errors and add to the degree of uncertainty for merging firms regarding merger enforcement;
- [C]onsider evidence "in the round" and do not rely on specific indicators (such as diversion ratios and margins) that are subject to measurement error;
- [W]hen determining safe harbor thresholds, guard against introducing an unnecessarily interventionist standard for merger screening and avoid capturing mergers very unlikely to result in anti competitive effects; and
- [B]e open to credible evidence pertaining to a range of factors including pro-competitive efficiencies.[6]

7. While these general principles apply across the range of economic measurement techniques in merger control assessments, *Business at OECD* has also commented in the past on the specific benefits and costs associated with various economic techniques, such as the Upward Pricing Pressure test (UPP).[7] Those tests are discussed in more detail below, along with a preview of other economic techniques with comments on their best use.

2. Price Pressure Tests

8. Price pressure tests are a number of methods that make use of the diversion ratio between merging firms and pre-merger gross margins to evaluate the incentive to increase

[5] *See* DANIEL GORE, ET AL., THE ECONOMIC ASSESSMENT OF MERGERS UNDER EUROPEAN COMPETITION LAW 12 (2015).

[6] OECD, ECONOMIC EVIDENCE IN MERGER ANALYSIS 291-99, 291 (2011), *available at* http://www.oecd.org/daf/competition/EconomicEvidenceInMergerAnalysis2011.pdf.

[7] *Id*. at 292-95.

price as a result of a merger.[8] There are a number of variants, including the Upward Pricing Pressure (UPP) and the Gross Upward Pricing Index (GUPPI). The original aim of these measures was to provide an initial screen for identifying mergers that might cause competition concerns that were more accurate than just static market shares. However, a significant issue for business and its advisers in implementing these techniques as a merger screen is the availability of the necessary data at the pre-notification stage. Data required to estimate diversion ratios and margins are often not widely available and these metrics may be methodologically challenging to estimate.

9. A potential competition merger case most vividly illustrates the lack of reliable data problem in running various price pressure tests, including the simple diversion ratio and margin tests as well as UPP and GUPPI tests that use diversion ratios and margins as inputs. By definition, in a potential competition merger case, the merging parties do not currently compete in the same relevant market or at the same level of the supply chain. Thus, in a potential competition case, there will not be any historical win-loss or substitution records. Although customer surveys could help estimate potential diversion ratios in some situations, "such surveys are not entirely reliable to the extent that the competing product to which the merging incumbent's customers would be asked to switch does not yet exist, and thus customers may not yet know whether substitution is even feasible."[9]

10. Another main area of concern with pricing pressure tests is that intervention thresholds need to be set before any judgment is made about which mergers are sufficiently concerning to warrant further investigation.[10] This lack of thresholds against which to judge test results further contributes to the lack of certainty in merger review. This may result in type I errors and competition authorities inadvertently introducing a more interventionist standard for merger screening.

3. Event Studies Test

11. This method is aimed at inferring the potential effects of a proposed merger by examining past changes in market structure.[11] It has been embraced by the U.S. DOJ &

[8] RBB Econ., Conjectural Variations and Competition Policy: Theory and Empirical Techniques (2011), *available at* https://web.archive.org/web/20130818113513/http://oft.gov.uk/shared_oft/research/CV_Competition_Policy.pdf.

[9] Jennifer Cascone Fauver & Submaniam Ramanarayanan, *Challenges for Economic Analysis of Mergers Between Potential Competitors: Steris and Synergy*, Antitrust, Vol. 30, No. 3, Summer 2016, at 78, *available at* http://awa2017.concurrences.com/IMG/pdf/smmr16-fauver_ramanarayanan_c_.pdf.

[10] On a related note, the newly issued DOJ and FTC Vertical Merger Guidelines of June 30, 2020 removed a 20% safe harbor market share threshold that had been initially included in the Draft Vertical Merger Guidelines for public comments but criticized as both too high and too low. *See* Statement of Chairman Joseph Simons, Commissioner Noah Joshua Phillips, and Commissioner Christine S. Wilson Regarding Joint Department of Justice and Federal Trade Commission Vertical Merger Guidelines 2, *available at* https://www.ftc.gov/system/files/documents/public_statements/1577507/vmgmajoritystatement.pdf.

[11] Christopher R. Rybak & Loren K. Smith, *The Use of Econometrics in Merger Reviews*, Econ. Comm. Newsletter (ABA Antitrust Section), Spring 2020, at 12.

FTC in their joint Horizontal Merger Guidelines of 2010.[12] In some litigated merger challenges, it has proven to be quite important and powerful.[13]

12. As with other economic analysis methods, the effectiveness of this method depends on the quality of the input data. Often times, merging parties have access to only their own data. Nonetheless, the event studies method can still be useful in that merging parties can study "the effect of a previous merger or entry by one party on the other party's pricing and profitability without third-party information."[14]

4. Price-Concentration Studies Test

13. This method tries to infer potential competitive harms by "relat[ing] contemporaneous market structures to prices or sales."[15] It is aimed at determining "how the changes in market structure caused by the merger are likely to affect prices" by "comparing prices across markets with different market structures."[16]

14. However, in practice, this method may be difficult to apply in that it requires detailed information on not only the merging parties but also "a comprehensive dataset on ... third-party competitors."[17] In addition, there might be another type of reliability issue known as endogeneity bias that, for example, "markets with less desirable demand conditions will have fewer competitors."[18] This type of bias can result in a confounding correlation between prices and market structure and is likely to lead to erroneous conclusions about the effect of a proposed merger on prices and sales.

5. Conclusion

15. *Business at OECD* has submitted numerous comments on this topic in the past as part of its submissions on specific merger control topics. Its previous comments remain largely current and relevant.

16. Over the years, various economic analysis methods have been developed and adopted in varying degrees. They can help the business community and enforcement agencies better assess the potential competitive effects of proposed mergers. The

[12] U.S. DEP'T OF JUSTICE & FED. TRADE COMM'N, HORIZONTAL MERGER GUIDELINES § 2.1.2 (2010), *available at* https://www.justice.gov/sites/default/files/atr/legacy/2010/08/19/hmg-2010.pdf ("The Agencies look for historical events, or 'natural experiments,' that are informative regarding the competitive effects of the merger. For example, the Agencies may examine the impact of recent mergers, entry, expansion, or exit in the relevant market. Effects of analogous events in similar markets may also be informative.").

[13] Rybak & Smith, *supra* note 11, at 15 (citing Dennis Carlton, Mark Israel & Allan Shampine, Lessons from AT&T/Time Warner, *available at* https://www.competitionpolicyinternational.com/wp-content/uploads/2019/07/CPI-Carlton-Israel-Shampine.pdf) ("in the AT&T/Time Warner litigation the Judge found merger retrospectives, showing that 'the harmful effects that the DOJ claimed should have happened were not there,' particularly compelling.").

[14] Rybak & Smith, *supra* note 11, at 15 ("Indeed, one of the benefits of event studies is that factors that are fixed over time, such as the presence of third-party competitors, are implicitly controlled for without access to third-party data.").

[15] *Id*. at 12.

[16] *Id*. at 17.

[17] *Id*.

[18] *Id*.

effectiveness and reliability of any given economic analysis depends on the quality of data input. In practice, readily available data may not be of the type, extent and quality that a particular economic analysis model requires. Despite its shortcomings, however, economic analysis can and does help better understand the markets at issue in different ways.[19] Further developments and refinements in economic analysis have also broadened its usefulness as a tool for understanding various types and forms of merger transactions.[20]

[19] Fauver & Ramanarayanan, *supra* note 9, at 79 ("While establishing the likelihood of entry is typically more of a factual issue, economic analysis has an important role to play in validating the assumptions underlying the potential entrant's business plan, particularly assumptions relating to pricing, customer demand, and competitive responses from incumbents.").

[20] David Foster, James Baker & Luís Campos, *The Elephants in The Room: Challenges to Competition Policy*, COMPETITION (Frontier Econ.), 2019, at 20, *available at* https://www.frontier-economics.com/media/3263/the-elephants-in-the-room-competition.pdf ("the improved toolkit has brought other benefits. For example, the shift in approach from market definition to closeness of competition has arguably paved the way for more sophisticated analysis of non-horizontal mergers.").