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UK MERGER CONTROL DEVELOPMENTS IN Q1 2017

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Introduction

This update covers Q1 2017.

In it, I investigate three questions.

1. Whether the CMA's willingness to accept undertakings in lieu ("**UILs**") in phase has increased in the last two years and, if so, why?
2. What impact, if any, will Brexit have on UILs?
3. Whether the CMA's willingness to use GUPPI and IPR is declining?

In the second half of this update, I round up Q1 developments in de minimis and exiting firm.

Is the CMA increasingly willing to accept UILs in phase 1 and, if so, why?

In the last two years,¹ the CMA has cleared more cases on the basis of UILs than it has referred to phase 2.

By contrast, in the two years to April 2006, more than three times as many cases were referred to phase 2 than were cleared on the basis of UILs.

This is a huge difference.

Why might it have arisen?

Is it a function of the sampling periods? There doesn't seem to be anything special about the "old" data for the two year period to April 2006 as similar results are seen in subsequent years. By contrast, the more recent data is very different from the immediately preceding years. So, the data has undoubtedly changed recently and we need to consider whether the change is an uninteresting consequence of variations in case mix or instead evidences a substantive shift.

We can rule out any change in the willingness of companies to obtain approval on the basis of UILs: there has always been a strong preference to get on with managing the merged business if the remedial price is a manageable one.

We can also, I think, rule out the idea that the CMA is departing from its published guidance: it would hardly tell the world it was going to do one thing and then consistently do another.

This leaves two candidate explanations, both of which arise from the Enterprise and Regulatory Reform Act 2013.

The first is that UILs are being accepted more frequently because parties no longer need to make their remedies proposals against the issues paper but instead can do so having seen the CMA's finalised phase 1 reasoning on SLC. It was certainly the case that, under the old system, companies were unhappy at having to propose remedies without knowing the precise details of the competition problem and many suspected (wrongly) that the CMA would be more likely to find a broader SLC if they proposed broader remedies. So it may be the case that, historically, there were accommodations that could have been reached (i.e. merging parties would have been willing to offer UILs that the CMA would have accepted) but were not, because of the process. However, I am not convinced that this category is a large one. My experience under the old system was that, after criticising the process (sometimes extensively), companies made their best

¹ All data relied on in this section is from <https://www.gov.uk/government/publications/phase-1-merger-enquiry-outcomes>. (Strictly, the data for the last two years is for the year 2015/16 and from April 2016 to the end of February 2017.)

offer because the reward in terms of avoiding the delays and costs/hassles of phase 2 made it worth their while to do so.

The second candidate explanation is that, since the formation of the CMA, the phase 1 decision maker has had access to advice from the Remedies, Business and Financial Analysis team that effectively joined the CMA from the Competition Commission. The idea here is that a phase 1 decision maker is much better placed to assess whether a remedies proposal offers a “clear-cut” solution to a competition problem (and therefore to accept UILs in marginal cases) if the decision maker has advice not only from a group that is expert on remedies but the very same group that would be providing advice on remedies to any phase 2 panel.

It is, of course, difficult to establish whether this idea is correct. However, looking at the Q1 2017 cases, it is reasonable to ask whether the CMA’s potential willingness to accept UILs in MasterCard / VocaLink would have been observed had the case arisen in, say, 2005 or 2006. In that case, the CMA found that the merger would reduce from 3 to 2 the number of credible providers of infrastructure services to the LINK ATM network across the UK, which might harm the LINK scheme when it invited bids for a new infrastructure provider. The CMA is consulting on a remedies package which includes VocaLink making its connectivity infrastructure available to a new supplier of infrastructure services, VocaLink transferring or licensing its IP rights relating to a messaging standard which is used when customers use cash machines and VocaLink contributing to LINK members’ switching costs. It is not certain whether the CMA will accept these remedies. However, they are, on their face, fairly complex. What connectivity infrastructure will be required by the as yet unidentified competitor? How can the CMA be confident that the remedies include everything that is required? What is the position with updates or amendments to the messaging standard? These sorts of questions can often be resolved by careful investigation by experts on remedies at the CMA, precisely the experts to whom the phase 1 decision maker now has access.

Of course, we can hardly base a conclusion on a single case, MasterCard, let alone a single case that has not yet been decided. However, looking back to cases prior to Q1 2017, there are others where UILs have been accepted, but which might have been referred had they arisen, say, 10 years earlier. Most clearly, in Müller UK & Ireland / Dairy Crest (remedies decision of 29 October 2015) a complex remedy to sponsor new entry was accepted in phase 1 in a case of a partially failing firm.

What impact will Brexit have on UILs?

The CMA’s approach to UILs raises two issues concerning Brexit.

First, when the UK has parallel jurisdiction over large international mergers that are being reviewed in Brussels (e.g. Kraft Heinz / Unilever, had it progressed), it will be anomalous if the EU Commission accepts phase 1 remedies and the CMA, considering markets in which competitive conditions are comparable, rejects equivalent remedies because its guidelines are more conservative. A consequence of Brexit will therefore be that companies will put pressure on the UK to align its UILs guidelines more closely with the EU Commission’s remedies guidelines.

Secondly, the volume of merger cases within the UK’s jurisdiction will increase significantly following Brexit. In his speech of 4 February 2017, Andrea Coscelli (acting CEO of the CMA) broadly estimated that the CMA could face an additional case load of between 30 and 50 phase 1 mergers which translate into six or so phase 2 investigations (cf. the historic data of 6 references in 2014/15, 11 in 2015/16 and 5 in the CMA year to February 2017). This significant increase in the CMA’s workload should, of course, result in a significant increase in funding, but it is not possible to forecast how those budget discussions will progress. Presumably, they will depend in part on the impact, if any, of Brexit on the UK’s tax take. If the CMA does not receive a pro rata increase in funding to cover its increased workload, a more flexible approach to UILs may help the CMA to focus its resources on delivering the best overall outcomes for consumers.

There is another way in which Brexit may affect the volume of cases requiring phase 2 investigations. For so long as the UK’s future trading relationship with the EU (including any tariffs) is unclear, it seems to me that it may be more difficult for the CMA to satisfy itself that the relevant geographic frame of reference is broader than the UK or that imports will continue in similar volumes to those observed to date (or increased volumes in response to a price increase). The CMA will clearly not start making forecasts about the outcome of the UK’s negotiations with the EU, but it will presumably have to take into account the uncertainty. And that might, in some cases, tip the balance into a finding that there is a realistic prospect of an SLC.

For further analysis of the implications of Brexit for merger control, see the articles by Alison Berridge and me on the Monckton Brexit blog at <https://www.monckton.com/brexit-blog/>.

Is the CMA becoming less willing to use GUPPI and IPR?

Gross Upward Pricing Pressure Index (GUPPI) and Illustrative Price Increases (IPR) calculations have been considered (or, in some instances, not considered) in several cases during Q1 2017. (For details of GUPPI and IPR calculations, see Parker & Majumdar “UK Merger Control”, 2nd ed., section 12.2.5 or Parr, Finbow & Hughes “UK Merger Control: Law and Practice”, 3rd ed., paras 9-082 and ff.)

It is possible to read those decisions (or omissions from those decisions) as evidencing a reduction in the CMA's enthusiasm for GUPPI and IPR, although I fully acknowledge that this is a rather tentative idea that requires further investigation.

In VTech / LeapFrog (phase 2 report of 12 January 2017), the CMA identified relatively high diversion ratios in children's tablet computers at para. 8.113 and gathered information on margins as noted in para. 7.31(a), yet the phase 2 panel did not go on to calculate GUPPI or IPR. Whilst the transaction was not in retailing, it was a merger between manufacturers of goods which were sold to retailers and the phase 2 panel considering AG Barr / Britvic, which was similar in this respect (a proposed merger of manufacturers of soft drinks), did consider an IPR at paras 6.63 to 6.65 of a report published in July 2013. There have also been two phase 1 decisions in Q1 2017 where GUPPI or IPR calculations might have been expected, given previous decisions in the market, but were not carried out.

First, in a decision of September 2013 in One Stop Stores / Alfred Jones (Warrington), the CMA carried out IPR calculations in a merger of convenience stores (see paras 35 ff.) Yet in Martin McColl / Cooperative Group, a decision published on 26 January 2017 in another fairly complex merger of convenience stores, there was no mention of IPR calculations.

Secondly, in Cineworld / City Screen (phase 2 report of 8 October 2013) the CMA used a GUPPI calculation in a cinemas merger in both phase 1 (see para. 55) and phase 2 (see para. 6.53(c)). By contrast, in Cineworld / Empire Cinemas (phase 1 decision published on 4 January 2017), the CMA did not carry out a GUPPI calculation, even though the merger raised difficult issues (the CMA commissioned its own survey in phase 1 for one area) and the purchaser was (again) Cineworld. The phase 1 decision states at fn. 45 that the CMA did not rely on a GUPPI calculation because it “*did not have accurate information on the Parties' profit margins*”. On its face, there is nothing in fn. 45 to suggest that the CMA is any less keen on GUPPI and IPR calculations than historically. Nevertheless, the contrast with the City Screen decision is noteworthy, at least at first blush, given that the purchaser was the same in both cases: in the earlier case the data had been considered adequate; but in the later case, it was not.

However, the apparent difference between the two Cineworld cases is considerably less striking when they are read together with AMC / Odeon & UCI, which was decided on 8 December 2016. In that cinemas merger, the CMA *did* rely on a GUPPI calculation at

paras 57 to 59 which tends to suggest that fn. 45 of the Empire Cinemas decision should be read at face value.

Finally, in the other phase 2 decision published in Q1 2017 (Diebold / Wincor, phase 2 report of 16 March 2017), the parties argued that a GUPPI calculation supported their claim that the merger would not result in anti-competitive effects (see para. 6.85). This argument had some difficulties because GUPPI calculations are generally used to indicate mergers that raise concerns necessitating further investigation, rather than as a form of screening for mergers which do not. In any event, the CMA rejected the argument for reasons that are of some interest. In addition to observations about the detail of the work that had been carried out in that case, the CMA made two points at para. 6.86. First, “*GUPPI is normally only considered useful in markets where the trade-off between the price and the proportion of customers that choose a given product (or its alternatives) can be observed or measured to some material extent. In the case of markets with bidding processes, observation or measurement of this trade-off may not be possible because in each tender, there is generally only one customer that chooses only one winner.*” On this reasoning, one might have expected a GUPPI calculation to have been “*useful*” in VTech / LeapFrog but, as noted above, there was none.

Secondly, the CMA stated that “*The market for customer-operated ATMs is highly concentrated which means that firms are more likely to respond to each other's strategies, rather than acting as price takers. GUPPI only uses measures of diversion between the merging firms and does not take into account the structure of the rest of the market or the responses of competitors.*” In one sense, this is a familiar recitation of the limitations of GUPPI calculations. However, if the CMA were suggesting that the use of GUPPI may be inappropriate in a market that is highly concentrated, this would be very interesting, not least because many of the mergers the CMA examines are in markets that are at least “*concentrated*”, if not “*highly concentrated*”. (Certainly, the CMA's tone in Diebold differs from that in the phase 1 decision in The Original Bowling Company / Bowlplex, 17 August 2015, when a challenge to the appropriateness of a GUPPI calculation was robustly rebuffed at paras 69 to 70.)

Overall, if there is a trend away from GUPPI and IPR calculations, it is at a fairly early stage and is not yet established. If the CMA updates its Commentary on Retail Mergers, it will be informative to see what, if any, changes they make to the chapter on Upward Price Pressure Indices.

De Minimis

In its consultation document of 23 January 2017 on the de minimis exception to the duty to refer, the CMA invited views on its proposal to leave the guidelines unchanged except for increasing the upper threshold for potential eligibility to £15m (from £10m) and the threshold below which markets are generally not sufficiently important to justify a phase 2 investigation to £5m (from £3m).

The proposed changes are to be welcomed in the light of inflation and, looking a little further ahead, Brexit.

The most noteworthy aspect of the consultation is the CMA's emphasis on its potential to reduce the number of phase 1 investigations. The press release says "It is expected that the changes will reduce the number of mergers that are subject to investigations – in particular those subject to initial phase 1 examination." The same point is made in Sheldon Mills' quote in the press release. In making these comments, the CMA is not focused on saving the costs of phase 2 investigations or the costs of the "back end" of the phase 1 process (issues and decision meetings), but on avoiding the entire costs of a formal notification and inquiry.

The idea that de minimis might reduce the burdens on the CMA at phase 1 is not a new one. It is mentioned in the Exceptions to the Duty to Refer Guidelines at paras 2.44 and 2.45. However, the emphasis given to the topic in the 23 January 2017 consultation document and associated press release suggests that the CMA intends to place significant reliance on the issue in managing its phase 1 case load. The CMA is presumably looking for more public interest bang for the public buck.

There is a link between this topic and the first question raised above, namely whether the CMA is becoming more willing to accept UILs in phase 1. If that were so, then it might cut down the application of the de minimis principle since more cases might be ruled outside the de minimis exception on the basis that there are "in principle" more likely to be UILs available.

Exiting firm

Finally, a brief update on developments in exiting firm.

East Coast Buses / First Scotland East is an unusual case as the facts were particularly clearly evidenced. The decision is noteworthy as the defence was accepted in phase 1 even though the asset had not been actively marketed: see the discussion at para. 45.

Finally, in VTech / LeapFrog (phase 2 report published on 12 January 2017), the CMA stated at para. 5.18 "We acknowledge that the Altman Z Score may be a further indication of the weak financial position of LeapFrog". It therefore seems likely therefore that Altman Z Scores (which measure the likelihood of bankruptcy using information that is typically available in financial reports) will be routinely calculated in future existing firm cases.

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