

UK Merger Control Developments in Q2 2017

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Welcome to the second edition of our quarterly update on UK merger control. This quarter we ask, and try to answer, three key questions about developments in the period:

- The mystery of the missing casino: What lessons can retrospective studies teach us about analysing future entry?
- The unsuccessful pagers merger: what the bleep was going on?
- Reference test satisfied: black Wednesday?

The mystery of the missing casino: What lessons can retrospective studies teach us about analysing future entry?

“Antitrust, if it is to be taken seriously, should check its predictions against outcomes, and be ready to adjust accordingly.”

Put like this (by Vanessa Turner in the latest Antitrust¹) the point is blindingly obvious. Of course we must see how we did, so as to do better in future. The CMA's recent publication of no fewer than two retrospective studies of recent merger decisions is therefore very welcome.

The next challenge comes in interpreting the data gathered in these studies. Are there lessons for the CMA and merging parties? Both of the UK studies feature cases involving entry, and this article looks at their implications for future cases in which the CMA must assess whether, how soon and how successfully a firm will enter a new market.

The first study, an external report prepared by KPMG, looks at eight recent clearance decisions in which the prospect of new entry or expansion had played an important part in allaying competition concerns.² KPMG analysed whether the anticipated entry or expansion had come about and, where possible, how the market had evolved in terms of prices or market shares.

The second updates the CMA's own ongoing evaluation of past merger remedies, looking back at two cases, one of which involved a remedy aimed at stimulating new entry.³ Again the CMA looked at subsequent events in

¹ Vanessa Turner: “Antitrust in the Globalized World: Where to Next?”, Antitrust, Vol. 31, No. 2, Spring 2017.

² KPMG: “Entry and expansion in UK merger cases: An ex-post evaluation”, KPMG LLP, April 2017.

³ CMA: “Understanding past merger remedies: Report on case study research” (CMA48), updated 6 April 2017.

the market to analyse how successful the remedy had been in resolving the identified SLC.

At first the studies make alarming reading. The CMA has repeatedly predicted entry that did not in fact occur: a cinema in Brighton, car clubs in London, a manufacturer of layer pads for stacking bottles and a casino in Edinburgh.⁴ Other predicted entry was slower or less effective than forecast. Only in a few cases did events play out in the way the CMA thought they would.

However, entertaining as it can be for practitioners to watch the regulator appear to stumble, these outcomes do not tell us much by themselves:

- The CMA applies probabilistic tests: for example at Phase II its task is to decide whether the merger is more likely than not to lead to an SLC. It is inherent in that test that it should clear a merger representing a 49% risk of an SLC. And if you do that 100 times, you will have cleared 49 SLCs. Such clearances (sometimes called type II errors) are not “errors” at all: they are just part of how the system works.
- In both studies the cases were selected for a range of reasons, among which was the prospect that the analysis would be interesting. These are therefore not random samples, and indeed it is very possible that the apparent “error” cases will have been more attractive to the authors on interest grounds, and disproportionately included.
- Both studies only consider cases in which entry was predicted, and are therefore only capable of identifying type II “errors”. They do not consider cases in which the CMA rejected entry arguments and may therefore have intervened unnecessarily in a merger (so called type I “errors”).

So what is really going on? Is the CMA applying its probabilistic tests well in an uncertain world? Or is it failing to form a justifiable view on the likelihood of entry? If the latter, does it tend to be unduly credulous or unduly cynical or neither? Could it do better?

KPMG addresses itself to the last question, and notes that there is one issue which featured in several “error” cases, and on which evidence was available which the CMA did not gather, or gather in detail. This is the constraint on entry posed by existing or future local regulation or policy, for example new private hire licensing arrangements in Sheffield affecting the ability of Uber to make an impact in the city. These barriers were also sometimes underestimated by the entrants themselves. While the sample is small, there appears therefore to be some evidence that local regulation has been a specific blind spot in merger analysis, and some justification for expending more resource examining local

⁴ *Cineworld/City Screen* (Phase II 2013); *Zipcar/Streetcar* (Phase II, 2010); *Cartonplast/Demes* (Phase I, 2010) and *Rank/Gala* (Phase II, 2013).

regulatory barriers in future cases.

The report enters more difficult territory however when it strays into suggesting that *any* pattern in the “error” cases ought to have a policy response. For example it notes that:

- The “error” rate among the Phase II cases it examined was high, something which it says “might suggest that some lessons can be learned”; and
- The CMA was less successful in predicting the success of entry in the form of new and innovative products than entry from existing players in closely related markets. The report recommends a “fuller assessment” in innovation type cases.

But there are good reasons why Phase II decisions, applying the balance of probabilities test, should experience a higher rate of this kind of error. And it is intuitive that innovative entry is more uncertain than plain vanilla entry from a neighbouring market. In these two cases a policy response is not necessarily needed.

And while it is unarguable that the CMA should do the best job it possibly can in every case, time, resource and evidence limitations may mean that a “fuller assessment” equates in practice to a higher evidential hurdle for parties making entry arguments. This simply results in the CMA trading readily observable type II errors (clearances leading to SLC) for harder to identify type I errors (interventions in non-problematic cases).

The CMA’s own approach is more sanguine. Its analysis of Rank/Gala considers the outcome in Edinburgh, where it required Rank to sell its “cold” (as yet unused) casino licence to a third party with the resources and commitment to develop a new casino. A willing purchaser was quickly found, paid a very significant sum (£179m), underwent a careful assessment by the CMA and acquired the licence. Yet three years later no progress had been made: the acquirer had taken no steps to develop the project and had sold the licence on to a third party, who also appeared to have made no progress.

As noted above, the mystery of the missing casino does not necessarily mean the CMA got it wrong. The CMA recognises this, and indeed goes so far as to conclude that its original decision was entirely justified: *“Based on the facts available to the CC at the time, as a result of its thorough purchaser suitability assessment, the decision to allow rank to sell the licence to GGV was appropriate.”*

Ultimately, the nature of these case studies mean that they offer relatively limited opportunity to draw conclusions about the CMA’s practice in this area.

The bigger and more important question is the one posed above: does the CMA have a bias towards over- or under- estimating the likelihood of effective entry? We know that the CMA rejects new entry arguments far more often than it accepts them (it rejects in the region of 7 such arguments for every one it accepts⁵). Learning something about these cases as well would provide a fuller picture and allow the CMA to assess how successful it is at striking a balance in entry cases.

It seems that the real mystery is not so much the one of the missing casino, but of the missing study.

The unsuccessful pagers merger: what the bleep was going on?

On 10 May 2017 the CMA announced that the reference test was satisfied in respect of Capita's proposed acquisition of Vodafone's pagers business. The merger would have combined the only two remaining suppliers in a declining, and relatively small market. Vodafone claimed that it would leave the market in around one to two years if the merger did not proceed, but the CMA rejected the exiting firm argument and used the pre-merger situation as the counterfactual. The CMA also chose not to exercise its de minimis discretion because the customers who would be adversely affected provide crucial services, such as hospitals, fire services and nuclear power stations.

Following the CMA's decision, a spokesperson for Vodafone made the following widely reported statement: *"Due to the expense involved with a prolonged investigation, Vodafone will not pursue the transaction and has made the decision to close down this business, which is based on ageing, standalone technology no longer supported by network vendors... We will do our utmost to minimise the impact on the 1,000 or so customers still using the service."*

Accordingly, Vodafone will close down its pagers business on 30 November 2017, less than seven months after the CMA's decision.

Two questions arise:

- Did the CMA reach the wrong decision on exiting firm / counterfactual, given Vodafone's subsequent decision to close its pagers business?
- How did the CMA apply the de minimis exception?

Did the CMA reach the wrong decision on exiting firm / counterfactual?

Vodafone announced its decision to abandon the merger and close its pagers business after the CMA had found that the reference test was satisfied. There

⁵ Data produced by Mat Hughes and Ben Forbes of Alix Partners, based on UK merger decisions between 1.4.10 and 31.3.16. A summary of the data is available here: <http://bit.ly/2sGZOcj>

was therefore no merger control advantage to Vodafone in making its closure announcement. It follows that the true counterfactual (i.e. the scenario that would have emerged if the merger did not proceed) was one in which Vodafone will exit the market in less than seven months.

Seen in that light, the impact of the transaction on competition was very limited and, had the merger taken place, customers would have benefited from an orderly transition to a new supplier without needing to negotiate a fresh contract.

However, Vodafone's announcement was (necessarily) not before the CMA when it made its decision. Instead, the decision relies heavily on a paper prepared for Vodafone's board as recently as August 2016 in which closure is identified as the least viable option when compared with a sale to Capita and (crucially) "*retaining and investing in the network*". Clearly, if the board's assessment was that remaining in the market was a more viable option than closure, then an exiting firm defence could not succeed.

Intriguingly, the decision also refers to Vodafone saying "*that Capita's approach in September 2015 prompted it to consider shutting down the Vodafone Paging business*". The CMA comments that "*the Merger appears to have prompted Vodafone's decision to strategically exit*". It is not clear from the decision how Vodafone's thinking evolved, but presumably the board paper of August 2016 was overtaken by further analysis which led Vodafone to conclude that if the merger did not go ahead then closure was Vodafone's best option, although that further analysis and conclusion was not documented either at all or to a standard comparable to the board paper of August 2016.

There is nothing wrong in principle with the idea that the (true) counterfactual might be influenced by the merger.

Most obviously, the fact of announcing a merger will affect the position of the business. In a declining market approaching obsolescence it might be expected that the party who ends up as proposed vendor will start to lose customers and specialist staff at a higher rate than absent the merger: entering the merger agreement might be taken as a signal that the vendor lacked ongoing commitment to the market.

More subtly, it is common for companies to observe that going through a detailed merger review gave them a better understanding of parts of their business; and a vendor might find that such an increased understanding caused it to change its plans for the business if the merger failed. This seems to have been Vodafone's position.

In other words, the CMA cannot conduct a public investigation into a merger (or, indeed, any other commercial conduct) from a secret hide with all other things

being equal: the process of analysing and observing may affect the market that is being observed, an idea familiar in physics (Heisenberg's uncertainty principle) and economics (Soros's reflexivity idea). (A similar issue arises in mergers when the theory of harm is that the merged group might surreptitiously adopt a strategy of marginalising competitors: the very process of the merger authority shining a light on the potential foreclosure strategy alerts market participants and makes the strategy in question harder, if not impossible, to implement.)

However, whilst this subtle effect is possible in theory, it is only reasonable to expect a degree of scepticism in practice on the part of the decision-maker if the change of analysis also turns out to be strongly supportive of an exiting firm claim.

The de minimis exception

The CMA found that the market size was £5-10m, but chose not to exercise its de minimis discretion because "*the Merger may have a significant impact on services, such as hospitals, fire services, and nuclear power stations, that rely on one-way WAP services.*"

It is clear from the evidence before the CMA that there are customers who need to be able in the public interest to communicate quickly and reliably who were convinced that mobile telephones were not an adequate alternative to pagers as a primary means of communication or, in some cases, as a back-up, e.g. in the case of a major incident.

Whilst this analysis is entirely unobjectionable, the parties can count themselves moderately unlucky.

When customers were asked what they would do if their current pager supplier withdrew their service, only 20 out of 49 customers said they would switch to the other supplier: Decision, para. 54(a). This evidence suggests that even a monopoly provider will need to work hard to retain customers. If Capita cannot identify which customers are truly dependent on pagers, the lessening of competition from the merger might well have been quite small.

Also, if the CMA had found that there was a serious question about whether Vodafone would exit from the market if the merger did not proceed, this would have reduced the strength of the CMA's concerns, since any lessening of competition might have been short lived and the merger would have advantages in facilitating an orderly transition of customers from Vodafone to Capita.

Indeed, in appropriate cases, the de minimis exception offers a potentially valuable way out of the practical problems created by the binary nature of the exiting firm and efficiency defences. The thresholds for both "defences" are

set at a high level, particularly in phase 1. A merger that fails to meet either of the thresholds may well be referred, even if the case was a “near miss”. (In other contexts, the CMA can avoid the binary issue, e.g. by placing limited weight on market definition and taking account of credible frames of reference and evidence of actual competition from outside the market.) The de minimis exception offers the authority the ability to “recycle” the rejected exiting firm or efficiencies submissions and take them into account in a more nuanced fashion as factors relevant to the exercise of the de minimis discretion.

This may be of particular value in declining markets approaching obsolescence. Imagine a market for legacy IT systems, with high fixed costs and low variable costs. The two suppliers compete aggressively against one another and price falls. Neither has a business case to make the investments necessary to continue to provide the service to an acceptable standard in the future. If neither invests, standards will fall and this will ultimately result in customers switching to other products. The parties wish to merge so they have a business case for the necessary investments. Theoretically, this ability to invest is a merger efficiency and the (monopoly) merged group’s pricing incentives will be driven by its low variable costs and the risk of losing customers forever to newer technologies. Nevertheless, the CMA would reject arguments that there is no SLC (despite the arguments about the merged group’s pricing incentives and the “gone forever” nature of customer switching), and is likely (depending on the evidence) to reject exiting firm and efficiencies defences. But if there were substantial merit in any or all of the three arguments, they might result in the de minimis exception being exercised in favour of the transaction.

Reference test satisfied: black Wednesday?

On Wednesday 10 May 2017, within a four hour period, the CMA announced that the reference test was satisfied in respect of three separate mergers. That morning fell in the middle of a prolific period for the CMA: over the fortnight centred on 10 May, the CMA found the reference test was satisfied in no fewer than five merger cases.

Of the five, the proposed pagers merger – which is discussed in a separate article in this newsletter - was abandoned, and *Solera / Autodata* is set to be resolved through undertakings in lieu.

This left the CMA to deal with three phase 2 references starting at similar times and with high levels of activity expected over the summer. The CMA has managed the pressure on resources by appointing just three members to two of the three cases: *Cardtronics / DirectCash Payments* and *Euro Car Parts / Andrew Page*. Indeed, the two inquiries have two members in common. The third of the phase 2 investigations is *Just Eat / Hungryhouse*, where four members have been appointed.

In *Cardtronics*, the CMA relied on evidence from “interviews” with the parties’ “BDMs – employees who are involved in day-to-day contact with customers and have responsibilities for specific postcode areas.” It is not clear from the CMA’s decision how these “interviews” came about. They may be quite trivial: the parties and the CMA may simply have agreed that it would help the CMA’s understanding to be able to talk directly to the BDMs, rather than raising written information requests. On the other hand, the CMA may have decided that it would obtain better evidence by using its powers to require the BDMs to attend for interviews, rather than compelling the production of information and documents. If the latter, this will be an interesting area to watch.

On a mundane note, there are extensive redactions to the public version of the *Just Eat* decision. It is possible that some of these may go further than is necessary. For example, it appears from para. 142 that the number of restaurants listed on Just Eat has been redacted, even though Just Eat’s website says it has “27,000+” partner restaurants. Similarly, the discussion of the counterfactual involves redactions to the entirety of 25 consecutive paragraphs and 25 consecutive footnotes, even though the CMA’s analysis is subsequently summarised in para. 127, which raises the question whether some at least of paras 20 to 45 could have been published.

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