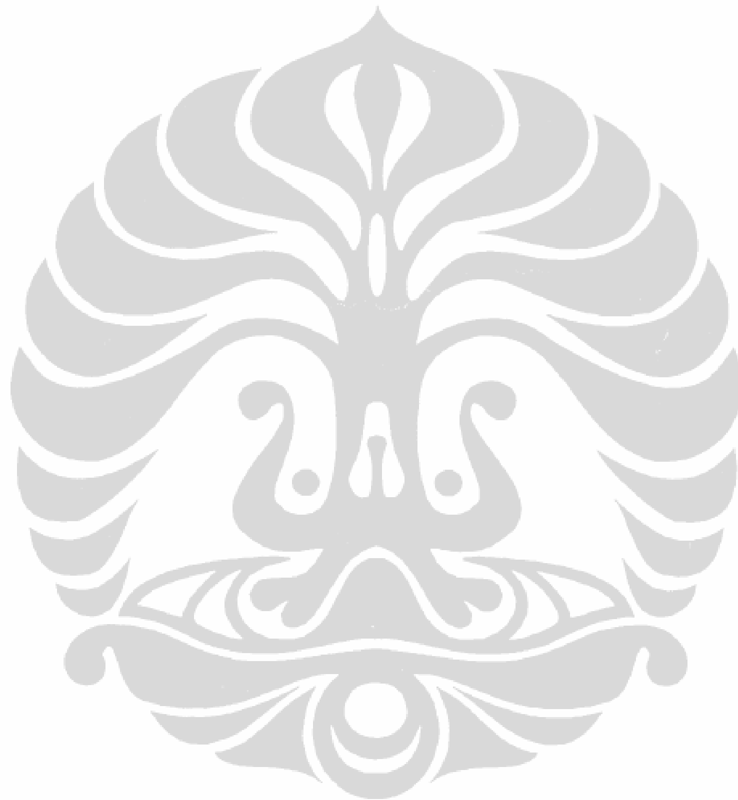
Lampiran 1

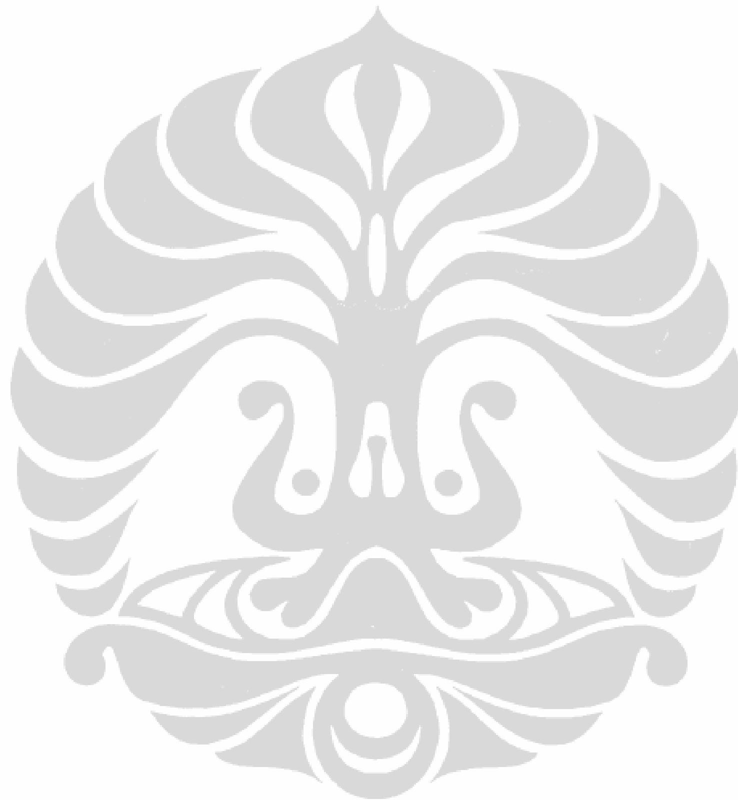
Kuesioner yang Digunakan dalam Survey



Lampiran 2

Merger Guidelines yang Diterbitkan oleh

Australia Competition and Consumer Commission (ACCC)



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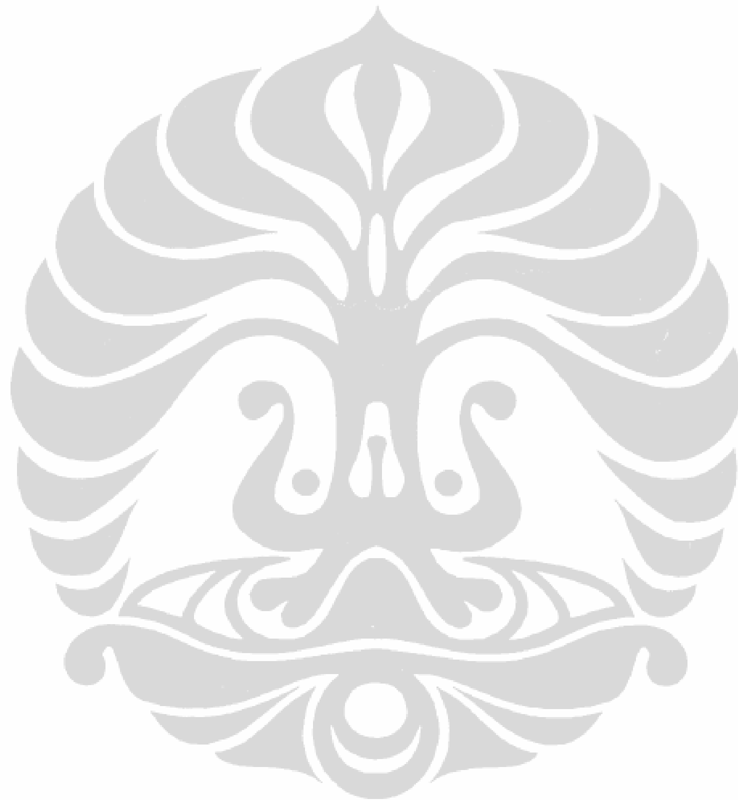
Lampiran 3

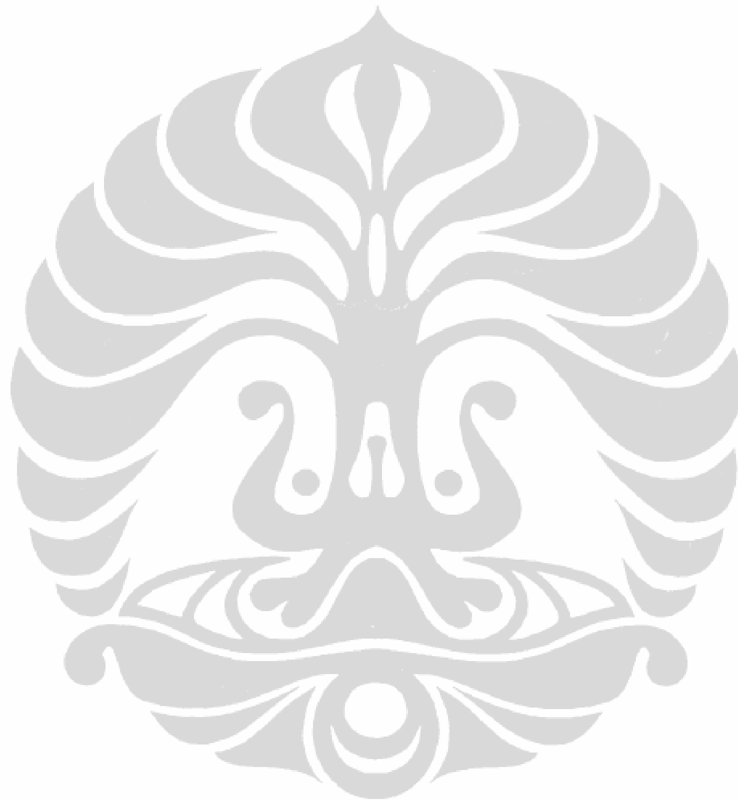
Guidelines on the Definition of Relevant Market

yang Diterbitkan oleh Rekabet, Turki



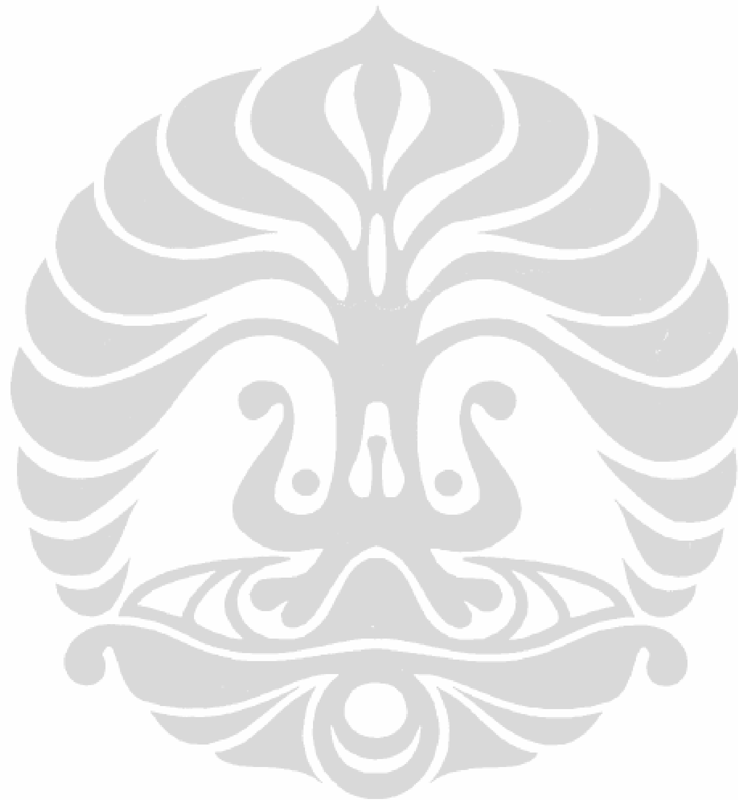
Lampiran 4

Market Investigation References: Competition Commission Guidelines



Lampiran 5

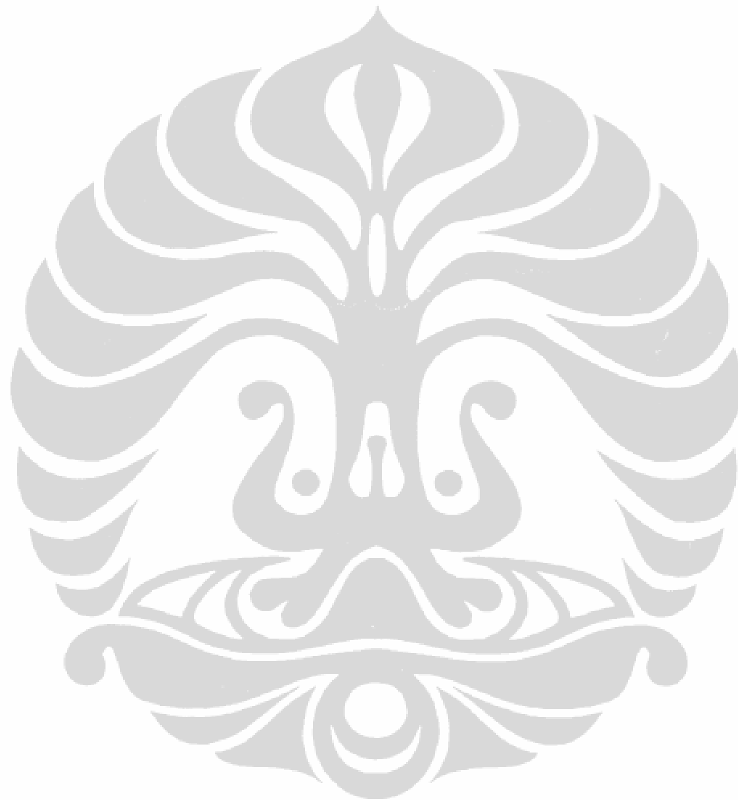
Commission Guidelines on Market Analysis and the Assessment of Significant Market Power under the Community Regulatory Framework for Electronic Communications Networks and Services



Lampiran 6

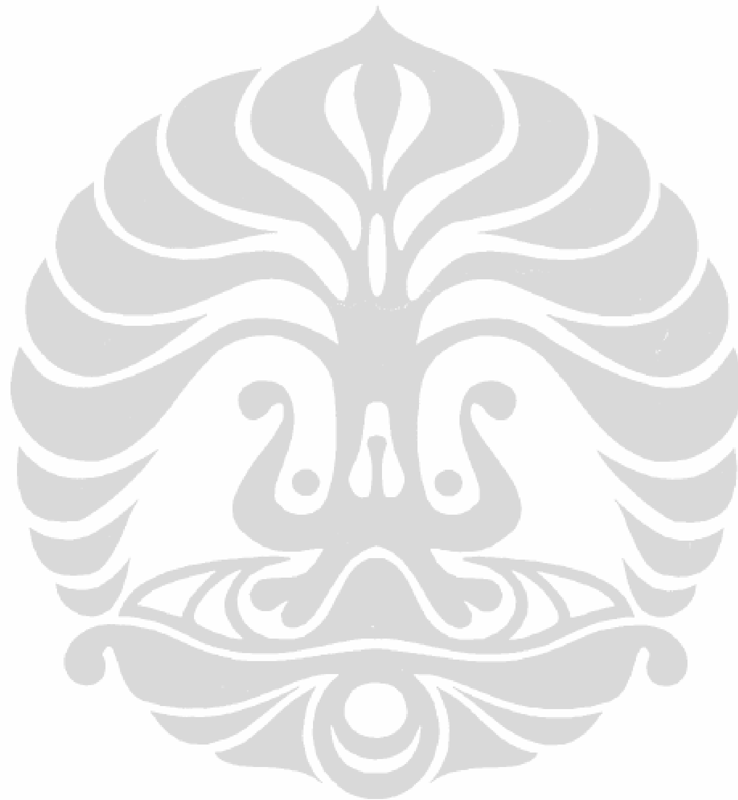
Malaysian Communications and Multimedia Commission

Guideline on Substansial Lessening of Competition



Lampiran 7

Methodology for the Definition of Telecommunications Markets diterbitkan oleh Telecommunications Regulatory Authority Bahrain



KUESIONER TENTANG LAYANAN TELEKOMUNIKASI

I. Mohon dilengkapi terlebih dahulu identitas Anda!	
Usia	:
Jenis Kelamin	:
Pendidikan terakhir	:
Bekerja	: Ya/Tidak

II. Mohon lingkari pada alternatif yang Anda pilih!

No.	Pernyataan		
1.	Memiliki telepon genggam	Ya	Tidak
2.	Menggunakan operator berbasis GSM (Telkomsel, Indosat, XL, Axis, Three)	Ya	Tidak
3.	Menggunakan operator berbasis CDMA (Flexi, Esia, Fren/Mobile 8)	Ya	Tidak
4.	Biasa menggunakan SMS secara bergantian dengan telepon biasa/*voice call*	Ya	Tidak
5.	Biasa menggunakan SMS secara bergantian dengan *voice mail*	Ya	Tidak
6.	Biasa menggunakan SMS secara bergantian dengan MMS	Ya	Tidak
7.	Biasa menggunakan SMS secara bergantian dengan *push e-mail*	Ya	Tidak
8.	Biasa menggunakan SMS secara bergantian dengan *messenger/chatting*	Ya	Tidak
9.	Lebih sering menggunakan SMS dibandingkan layanan telekomunikasi lainnya	Ya	Tidak
10.	Masing-masing layanan telekomunikasi memiliki fungsi dan karakter yang berbeda sehingga tidak dapat saling menggantikan	Ya	Tidak
11.	Tarif SMS menjadi pertimbangan utama dalam memilih operator	Ya	Tidak
12.	Bila tarif SMS naik 10%, maka saya akan menggunakan telepon secara langsung/ *voice call*	Ya	Tidak
13.	Bila tarif SMS naik 10%, maka saya akan menggunakan layanan MMS	Ya	Tidak
14.	Bila tarif SMS naik 10%, maka saya akan menggunakan layanan *voice mail*	Ya	Tidak
15.	Bila tarif SMS naik 10%, maka saya akan menggunakan layanan *push e-mail*	Ya	Tidak
16.	Bila tarif SMS naik 10%, maka saya akan menggunakan layanan *messenger*, baik yang dikeluarkan oleh operator/*handset*/jejaring sosial	Ya	Tidak
17.	Bila tarif SMS naik 15%, maka saya akan menggunakan telepon secara langsung/ *voice call*	Ya	Tidak
18.	Bila tarif SMS naik 15%, maka saya akan menggunakan layanan MMS	Ya	Tidak
19.	Bila tarif SMS naik 15%, maka saya akan menggunakan layanan *voice mail*	Ya	Tidak
20.	Bila tarif SMS naik 15%, maka saya akan menggunakan layanan *push e-mail*	Ya	Tidak
21.	Bila tarif SMS naik 15%, maka saya akan menggunakan layanan *messenger*, baik yang dikeluarkan oleh operator/*handset*/jejaring sosial	Ya	Tidak

Terima kasih atas partisipasi Anda

Australian Competition & Consumer Commission

Merger guidelines

NOVEMBER 2008

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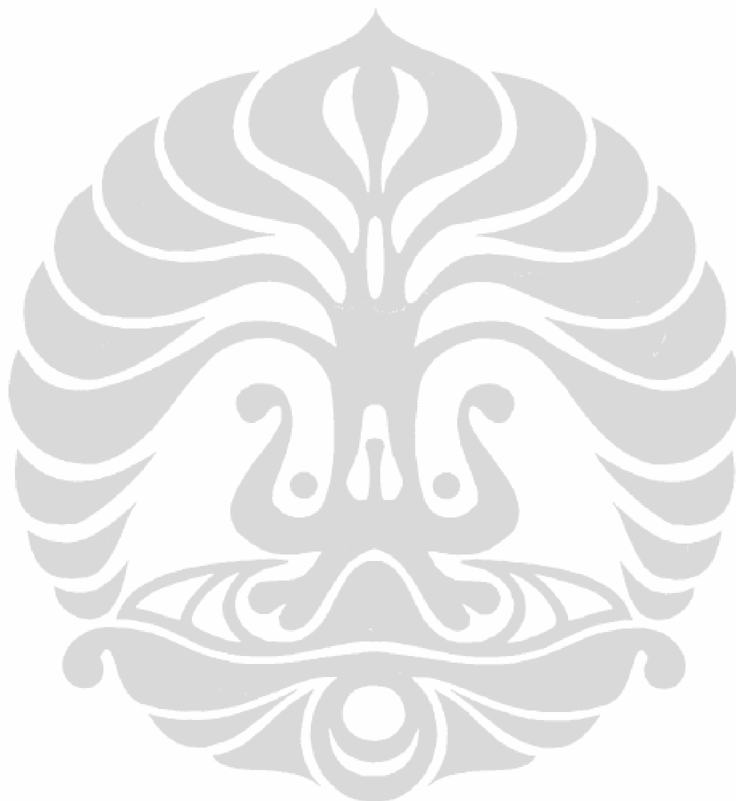

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Australian
Competition &
Consumer
Commission

Merger guidelines

NOVEMBER 2008

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Foreword

The Australian Competition and Consumer Commission's approach to merger assessment has evolved significantly since the ACCC last published analytical guidelines in the area of mergers in 1999. The changes in the ACCC's approach have been developed in line with international best practice, contemporary views on anti-trust analysis and the ACCC's experience since 1999. These revised guidelines have benefited from valuable input from the business and trade practices advisory community on an earlier draft, which was released for consultation in February 2008.

These revised guidelines outline the general principles underpinning the ACCC's merger analysis under s. 50 of the *Trade Practices Act 1974* (the Act). It is important to note that the approach taken in the revised guidelines is not radically different from the approach contained in the 1999 guidelines—the competition test is the same and analysis of the market and merger factors remains a vital element in merger assessment.

However, the approach to merger assessment has been developed with an increased emphasis on the competitive theories of harm and the effect of constraints, which facilitates a more integrated analysis. The changes to the guidelines do not represent a new approach by the ACCC but are rather a better reflection of the approach being undertaken by the ACCC to merger reviews.

The ACCC will continue to assess each merger on its merits according to the specific nature of the transaction, the industry and the particular competitive impact likely to result in each case. The general principles set out in these guidelines provide a framework within which mergers will be reviewed. Importantly, the application of those principles to different facts and situations may give rise to different results.

It is not possible for these guidelines to cover every issue or circumstance that may arise in a merger review. In practice, individual mergers involve a great variety of facts and situations, and the analysis of particular issues may need to be tailored to the specific circumstances of a merger or deal with competition issues not specifically considered in these guidelines. Therefore the ACCC proposes to apply the revised guidelines flexibly.

The ACCC's case-by-case approach to merger analysis is reflected in both the public competition assessments issued for mergers considered to be of major public interest and in the shorter summaries of reasons for merger decisions, which are available on the ACCC website for all public merger reviews. These guidelines, supplemented with the growing body of public competition assessments and reasons for decisions, should provide an enhanced level of predictability and certainty to merger parties, their advisers, the business community and the public.

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1. Introduction

1.1. Mergers and acquisitions are important for the efficient functioning of the economy. They allow firms to achieve efficiencies, such as economies of scale or scope, and diversify risk across a range of activities. They also provide a mechanism to replace the managers of underperforming firms.

1.2. In the vast majority of mergers, sufficient competitive tension remains after the merger to ensure that consumers and suppliers are no worse off. Indeed, in many cases consumers or suppliers benefit from mergers. In some cases, however, mergers have anti-competitive effects. By altering the structure of markets and the incentives for firms to behave in a competitive manner, some mergers can result in significant consumer detriment.

Section 50 of the Act

1.3. Section 50 of the Act prohibits mergers that would have the effect, or be likely to have the effect, of substantially lessening competition in a market.

1.4. Section 50(3) requires the following non-exhaustive list of matters (or 'merger factors') to be taken into account when assessing whether a merger would be likely to substantially lessen competition:

(a) the actual and potential level of import competition in the market

(b) the height of barriers to entry to the market

(c) the level of concentration in the market

(d) the degree of countervailing power in the market

(e) the likelihood that the acquisition would result in the acquirer being able to significantly and sustainably increase prices or profit margins

(f) the extent to which substitutes are available in the market or are likely to be available in the market

(g) the dynamic characteristics of the market, including growth, innovation and product differentiation

(h) the likelihood that the acquisition would result in the removal from the market of a vigorous and effective competitor

(i) the nature and extent of vertical integration in the market.

1.5. These matters or 'merger factors' illuminate the policy intent underlying s. 50.[1] In particular, they highlight key potential constraints on a merged firm (for example, new entry and imports) and identify market characteristics that could potentially affect the impact of a merger on competition (for example, growth in demand, innovation or the level of vertical integration). Other factors not listed in s. 50 may also be relevant to a merger assessment.

1 Australia, House of Representatives 1992, *Debates*, vol. HR186, p. 2406.

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Types of s. 50 merger assessments

1.6. Merger parties have three avenues available to have a merger considered and assessed[2]:

- the ACCC assesses the merger on an informal basis
- the ACCC assesses an application for formal clearance of a merger
- the Australian Competition Tribunal (the Tribunal) assesses an application for authorisation of a merger.

1.7. As merger parties are not legally required to notify the ACCC of a merger, they also have the option of proceeding with the merger without seeking any regulatory consideration.[3] However, this will not prevent the ACCC from subsequently investigating the merger, including making public inquiries to assist its investigation and, if necessary, taking legal action. Proceeding without regulatory approval may put merger parties at risk of the ACCC or other interested parties taking legal action on the basis that the merger would have the effect, or be likely to have the effect, of substantially lessening competition in one or more substantial markets in contravention of s. 50.

Informal clearance

1.8. The informal clearance process enables merger parties to seek the ACCC's view on whether it will seek an injunction under s. 50 to stop a merger from proceeding. Information on the procedural aspects of informal clearances can be found in the ACCC's *Merger review process guidelines*.

1.9. If the ACCC forms the view that a merger proposal is likely to contravene s. 50, the merger parties may decide either:

- not to proceed with the merger
- to provide a court enforceable undertaking to address ACCC concerns, or
- to proceed and defend court action under s. 50.

If the merger parties seek to proceed with the proposal, the ACCC can apply to the Federal Court of Australia for an injunction to prevent the merger from proceeding, as well as divestiture or penalties.[4]

Formal clearance

1.10. Application may be made to the ACCC for formal clearance. If granted, this will provide merger parties with legal protection from court action under s. 50. Formal clearance may only be granted if the ACCC is satisfied that a merger would not have the effect, or be likely to have the effect, of substantially lessening competition in a market (within the meaning of s. 50). Clearance may be granted by the ACCC with conditions (usually in the form of a court enforceable undertaking).

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2 A reference to a 'merger' in these guidelines includes a proposed merger, unless the context otherwise specifies.

3 Parties may also seek a declaration from the Federal Court that the acquisition will not contravene s. 50.

4 Other parties (such as customers, competitors or other interested parties) may also apply to the Federal Court for a declaration (that the acquisition will not contravene s. 50) and/or divestiture, and any person suffering loss or damage as a result of a merger that breaches s. 50 can apply for damages.

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1.11. If the ACCC denies clearance, the merger parties may apply to the Tribunal for review of the ACCC's decision or face the same options available following an adverse informal review as outlined in paragraph 1.9.

1.12. Information on the procedural aspects of formal clearances can be found in the ACCC's *Formal merger review process guidelines*.

Merger authorisation

1.13. Merger parties may also seek legal protection from court action under s. 50 by applying to the Tribunal for authorisation. The Tribunal may grant authorisation if it is satisfied that the proposed merger is likely to result in such a benefit to the public that the merger should be allowed to occur. Information on the procedural and analytical aspects of applications for merger authorisation should be directed to the Tribunal (www.competitiontribunal.gov.au).

Types of mergers

1.14. As outlined in appendix 2, s. 50 applies to a wide variety of mergers and acquisitions. A 'merger' involves the shareholders of two companies becoming the shareholders of a new merged company. An 'acquisition' occurs when one company acquires a shareholding in, or the assets of, another company. Generally, when assessing its impact on competition, little turns on whether a transaction is, strictly speaking, a 'merger' or an 'acquisition'. For convenience, these guidelines refer to 'mergers' and 'merger parties'.

1.15. These guidelines discuss three types of merger—in each, the merger may involve firms that are either actual or potential competitors:

- horizontal mergers—involving actual or potential suppliers of substitutable goods or services
- vertical mergers—involving firms operating or potentially operating at different functional levels of the same vertical supply chain
- conglomerate mergers—involving firms that interact or potentially interact across several separate markets and supply goods or services that are in some way related to each other, for example, products that are complementary in either demand or supply.

1.16. Each type of merger has the potential to affect competition in a different way and will therefore be analysed differently. While some competition issues and theories of competitive harm are presented separately in these guidelines, the ACCC will adopt an approach tailored to the particular nature of the merger.

Acquisition markets

1.17. These guidelines focus on potential competition concerns in supply markets into which the merged firm supplies goods and services. However, there could also be competition concerns in acquisition markets in which the merged firm acquires goods and services. In particular, the merged firm may be able to depress the price paid for the inputs below their competitive price by restricting its purchase of those inputs. The ACCC will apply an approach to acquisition markets that is analogous to that set out in these guidelines for supply markets.

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Purpose of these guidelines

1.18. These guidelines provide an outline of the broad analytical framework applied by the ACCC when assessing whether a merger is likely to substantially lessen competition under s. 50. These guidelines have been developed by the ACCC in relation to its functions under s. 50 and do not purport to represent the analytical framework that would be applied by the Tribunal in relation to its mergers functions.

1.19. These guidelines are designed to provide reliable, comprehensive and detailed information that merger parties, the business community, their advisers and the public can draw on to:

- assess the likely level of scrutiny a merger will receive from the ACCC—in particular, guidance is provided on when merger parties should notify the ACCC of a merger (the threshold for notification is outlined in chapter 2)
- increase understanding of the application of s. 50
- assist in structuring (or restructuring) mergers to avoid raising competition concerns
- identify the types of information that will assist the ACCC to reach a view on how a merger is likely to affect competition—to make informed and timely decisions, the ACCC relies on the cooperation of the merger parties, customers, competitors, suppliers and any other persons or bodies holding relevant information
- identify the ACCC's broad approach to remedying possible anti-competitive mergers through undertakings (see appendix 3).

1.20. These guidelines do not have any legal force in determining whether a merger is likely to contravene the Act—final determination of the issues is a matter for the courts.

1.21. It is not possible for these guidelines to cover every issue or circumstance that may arise in a merger review. In practice, individual mergers involve a great variety of facts and situations, and the analysis of particular issues may need to be tailored to the specific circumstances of a merger or deal with competition issues not specifically considered in these guidelines. Therefore the ACCC will apply these guidelines flexibly and may adapt the framework to specific issues where appropriate.

1.22. These guidelines are supplemented by public competition assessments published by the ACCC. These competition assessments outline how the principles contained in the guidelines have been applied to specific mergers.

1.23. These guidelines replace the 1999 *Merger guidelines*. They reflect the ACCC's analytical approach at the time of publication and may be revised periodically, as necessary, on the basis of new legal precedent, evolving insight and best practice. The latest version of the guidelines will be the version published on the ACCC website. In developing these guidelines, the ACCC has considered guidelines issued by overseas competition authorities and the work done by the International Competition Network.

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Contact with the ACCC

1.24. The Mergers and Acquisitions Group is responsible for assessing mergers under s. 50 and proposed mergers under s. 95AC of the Act.

1.25. Any inquiries about the ACCC's administration and analysis of merger reviews should be directed to:

Executive General Manager
Mergers and Acquisitions Group
Australian Competition and Consumer Commission
GPO Box 3131
Canberra ACT 2601

Email: mergers@accc.gov.au
Tel: (02) 6243 1368
Fax: (02) 6243 1212

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2. Notification threshold

2.1. While there is no compulsory pre-notification requirement for mergers in Australia, it is recommended that certain mergers that may be subject to the Act (see appendix 2) be voluntarily notified to the ACCC for review, well in advance of completion.

2.2. To assist merger parties and their advisers to determine whether they should notify the ACCC, the ACCC has developed a notification threshold, outlined below. This threshold has been established by the ACCC to filter and thereby limit the merger reviews it conducts to those mergers which, in its view, may potentially raise competition concerns. The notification threshold is set at a level that reflects the ACCC's experience in determining which mergers are more likely to raise competition concerns and therefore require further investigation.[5]

2.3. If merger parties believe their merger proposal will meet the notification threshold, they are encouraged to approach the ACCC on a confidential and informal basis as soon as there is a real likelihood that the merger may proceed to discuss possible competition issues and options for having the matter considered.

2.4. Merger parties are also encouraged to approach the ACCC where the ACCC has indicated to a firm or industry that notification of mergers by that firm or in that industry would be advisable.

2.5. Parties may choose to seek informal or formal clearance from the ACCC. The informal clearance process provides flexibility in terms of timeframes, information requirements and confidentiality, while the formal clearance process has mandated timeframes and information and transparency requirements.

2.6. If mergers that raise competition concerns are not notified to the ACCC in adequate time for it to conduct a review, the ACCC may seek to use its formal information-gathering powers and/or injunctive relief, to enable it to properly consider such mergers to ensure no anti-competitive harm arises.

2.7. Mergers that fall outside the notification threshold will rarely require investigation by the ACCC. However, the notification threshold is indicative only. It is intended to provide a starting point for identifying those mergers that may raise competition concerns and therefore require investigation in accordance with these guidelines. Importantly, the notification threshold should not be confused with the concentration threshold (set out in chapter 7) which the ACCC has regard to as part of an overall assessment of whether a merger is likely to substantially lessen competition under s. 50.

2.8. As market shares are an imprecise indicator of likely competition effects, a merger that does not meet the notification threshold may still raise competition concerns. The ACCC may therefore investigate such mergers, even if they have not been notified to it.

5 The ACCC determined the level of the notification threshold based on an analysis of all previous merger reviews where the ACCC released a statement of issues. A statement of issues is released by the ACCC where, after an initial assessment, it believes the merger requires further detailed assessment. The notification threshold is based on the market shares of the merged firm in matters that proceeded to this stage.

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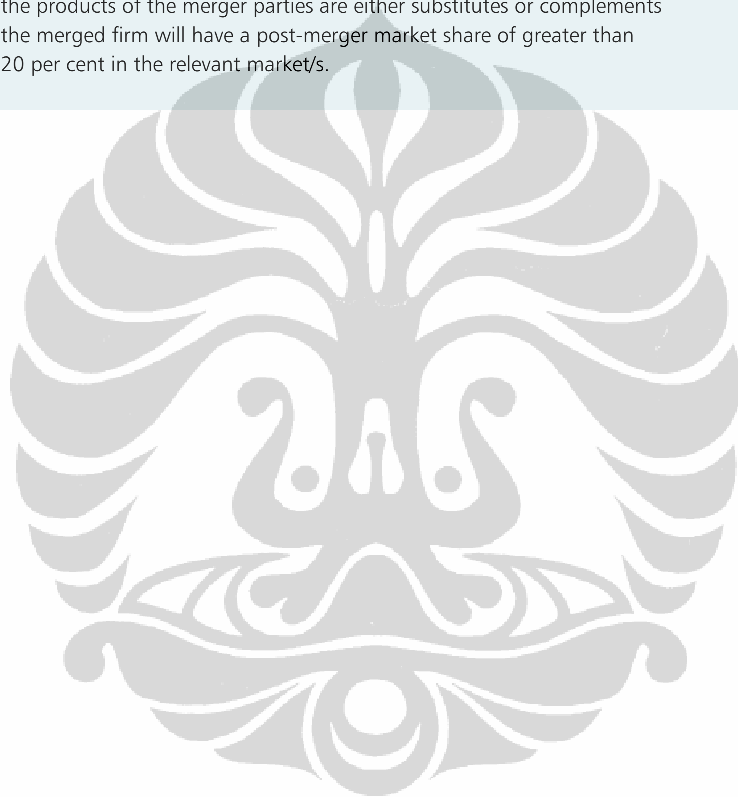
2.9. For simplicity, the notification threshold is based on market shares. The calculation of market shares depends critically on market definition. If there is uncertainty as to the relevant market, it is preferable that market shares be calculated on the basis of the market definition most likely to raise competition concerns. This will usually mean adopting a conservative rather than broad definition of the market, unless doing so would reduce or eliminate the overlap between the merger parties.

Notification threshold

Merger parties are encouraged to notify the ACCC well in advance of completing a merger where both of the following apply:

- the products of the merger parties are either substitutes or complements
- the merged firm will have a post-merger market share of greater than 20 per cent in the relevant market/s.



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3. The competition test

3.1. Competition is a state of ongoing rivalry between firms—rivalry in terms of price, service, technology and quality. Market participants are mutually constrained in their pricing, output and related commercial decisions to some extent by the activity of other market participants (or potential market participants). In other words, the greater the degree of competition in a market, the less market power each market participant will possess.

3.2. Mergers can alter the level of competition in a market. Some mergers enable the merged firm to meet customer demand in a way that facilitates more intense competition. Many mergers do not affect the level of competition at all because there are sufficient substitution possibilities to effectively constrain the merged firm.

3.3. Other mergers, however, lessen competition by reducing or weakening the competitive constraints or reducing the incentives for competitive rivalry.[6] Mergers that increase the market power of one or more market participants may be detrimental to consumers because they may lead to an increase in price, or deterioration in some other aspect of the service offering (see the text box below)—the level of market power will be dependent on whether alternative actual or potential supply options are available post-merger to effectively constrain the merged firm. If market structure and circumstances mean that there is limited potential for alternative supply options or substitution possibilities to constrain the merged firm, then it will be profitable for the merged firm to raise prices despite the potential for lost sales to alternative suppliers.

3.4. Further, mergers that increase market power may decrease economic efficiency (because transactions at the margin are deterred) thereby reducing gains from trade and total welfare.

Market power and increases in price

The most obvious and direct manifestation of an increase in market power is the ability of one or more firms to profitably raise prices post-merger for a sustained period. Market power can, however, be exercised in other ways. For example, a firm with market power may:

- lower the quality of its products without a compensating reduction in price
- reduce the range or variety of its products
- lower customer service standards, and/or
- change any other parameter relevant to how it competes in the market.

While the exact nature of competitive detriment caused by a merged firm's increased market power will vary depending on the particular circumstances of the matter, the ACCC often characterises an increase in market power as the ability to raise prices. References to 'raising prices' in these guidelines should therefore be read as implicitly incorporating the exercise of market power in other non-price ways.

6 For convenience the guidelines refer to any increase in market power as accruing to sellers in a relevant market. A merger can also lead to a substantial lessening of competition among buyers in a market. In such a situation, the increased market power of a buyer may enable it to profitably reduce prices or otherwise engage in behaviour that is detrimental to suppliers.

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Substantial lessening of competition

3.5. Not all mergers that lessen competition are prohibited by s. 50 of the Act; only those that lessen competition **substantially** are prohibited.[7] The term 'substantial' has been variously interpreted as meaning real or of substance[8], not merely discernible but material in a relative sense[9] and meaningful.[10] The precise threshold between a lessening of competition and a substantial lessening of competition is a matter of judgement and will always depend on the particular facts of the merger under investigation. Generally, the ACCC takes the view that a lessening of competition is substantial if it confers an increase in market power on the merged firm that is significant and sustainable. For example, a merger will substantially lessen competition if it results in the merged firm being able to significantly and sustainably increase prices.

3.6. The level at which an increase in market power is likely to become significant and sustainable will vary from merger to merger. For example, an increase in price that is very small in magnitude might also be significant. The ACCC considers that firms would generally be deterred from instituting a price increase, or only be able to institute it for a transitory period, where effective competitive constraints exist or where constraints are likely to become effective within a period of one to two years.

3.7. In some markets, particular characteristics, such as the prevalence of certain types of long-term contracts between buyers and sellers, may prevent a merged firm from exercising any market power it gains through the merger until some point in the future—for example, at contract renewal. If the exercise of market power is likely to be delayed in this way, the ACCC will focus on the period commencing at the point where market power would be exercised (for example, at contract negotiations).

3.8. As outlined in chapter 4, a substantial lessening of competition must arise in a market to contravene s. 50. However, this does not imply that a lessening of competition must apply to the entire market or to all aspects of competition in the relevant market.[11]

Competitive constraints and the 'merger factors'

3.9. In assessing whether a merger is likely to result in a significant and sustainable increase in market power, the ACCC must consider each of the 'merger factors' set out in s. 50(3) as well as any other relevant factors (see paragraph 1.4). These merger factors provide insight as to the likely competitive pressure the merged firm will face following the merger and the possible competitive effects of the merger. The assessment of the competitive effects is based on the theories of competitive harm—namely, unilateral and coordinated effects. Mergers result in unilateral and/or coordinated effects when they weaken or remove the competitive pressure on firms in a market. In cases where unilateral and/or coordinated effects amount to a significant and sustainable increase in the market power of the merged firm and/or other firms in a market, the merger is likely to substantially lessen competition in contravention of the Act.

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7 Under s. 4G, a lessening of competition includes, but is not limited to, preventing or hindering competition. Mergers likely to have the effect of substantially preventing or hindering competition are therefore also prohibited by s. 50.

8 Trade Practices Legislation Amendment Bill 1992, explanatory memorandum, paragraph 12.

9 Australia, Senate 1992, *Debates*, vol. S157, p. 4776.

10 *Rural Press Limited v Australian Competition and Consumer Commission* [2003] HCA 75 at 41.

11 *Dandy Power Equipment Pty Ltd v Mercury Marine Pty Ltd* (1982) ATPR 40–315 at 43,888.

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3.10. The merger factors cover a broad range of possible actual and potential competitive constraints[12] faced by the merged firm—some assist in identifying the presence of direct constraints[13] while others provide insight into less direct forms of constraint relating to either the structure and characteristics of the market[14] or the behaviour of actual and potential participants in a market.[15]

3.11. The ACCC recognises that competitive constraints are not static and strategic behaviour by market participants can affect competition. The significance of the merger factors, and the weight that is placed on them, will depend on the actual matter under investigation.

3.12. The likely presence of effective competitive constraints post-merger is a key indicator that a merger is unlikely to result in a substantial lessening of competition. While all the merger factors must be taken into consideration, it may not be necessary for all factors to indicate that the merged firm would face effective competitive constraints. In some cases a single effective constraint can be sufficient to prevent a significant and sustained increase in the market power of the merged firm, while in other cases the collective effect of several constraints may be required. Conversely, the absence of a single particular constraint is unlikely to be indicative of an increase in market power as a result of a merger.

3.13. Unilateral and coordinated effects are discussed in chapters 5 and 6 of this guideline, while chapter 7 sets out in more detail the relevance of each merger factor in deciding whether a merger is likely to result in a substantial lessening of competition in a market.

The forward-looking nature of the competition test

3.14. Section 50 requires a forward-looking analysis into the effects or likely effects of a merger, since analysis is generally conducted before the impact of a merger on competition can be observed. The ACCC therefore focuses on the foreseeable future (generally within one to two years) when considering market definition and each of the merger factors to determine whether a substantial lessening of competition is likely to occur. This raises a number of issues.

Likely effect

3.15. Mergers are prohibited under s. 50 if they would have the effect, or be **likely** to have the effect, of substantially lessening competition. Clearly a substantial lessening of competition must be more than speculation or a mere possibility for it to be likely, but it does not need to be a certainty. Importantly, a substantial lessening of competition need not be 'more probable than not', for the merger to contravene s. 50. Mergers are prohibited when there is a 'real chance' that a substantial lessening of competition will occur. However, a 'mere possibility' would be insufficient.[16] Ultimately, the determination of whether a substantial lessening of competition is likely will depend on the facts of the particular matter.

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12 In these guidelines, the term 'competitive constraints' refers to both actual and potential competitive constraints.

13 For example, the level of actual and potential imports, the height of barriers to entry, the degree of countervailing power and the availability of substitutes.

14 For example, the dynamic characteristics of the market, the level of concentration in the market, and the nature and extent of vertical integration.

15 For example, the likelihood that the acquirer would be able to significantly and sustainably increase prices or profit margins, whether the acquisition will result in the removal of a vigorous and effective competitor and other relevant factors.

16 *Australian Gas Light Company* (ACN 052 167 405) *v Australian Competition and Consumer Commission* (No 3) [2003] FCA 1525, at [348].

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With and without test

3.16. Merger analysis requires comparing likely future states—the future **with** the merger and the future **without** the merger. This comparison isolates the merger's impact on competition. For this reason, the competition test in s. 50 is sometimes referred to as a future 'with and without' test.[17]

3.17. The likely future state of competition without the merger (the counterfactual) will generally be similar to the state of competition prevailing at the time of the merger. However, in some cases taking the state of competition prevailing at the time of the merger as the benchmark for analysis could risk attributing a change in the level of competition to a merger, when the real cause is some other development that is unrelated to the merger and likely to occur regardless of the merger. Focusing on the state of competition prevailing at the time of the merger might also disguise a substantial lessening of competition in situations where a merger hinders or prevents competition that would otherwise have emerged.

3.18. The ACCC therefore uses information about the state of competition prevailing at the time of the merger to inform its assessment of the likely future state of competition without the merger. This applies to market definition and all the merger factors outlined in chapter 7. It also applies to likely developments involving the merger parties—in particular, mergers involving firms that are likely to be more effective competitors in the future and those involving failing firms.

3.19. However, the ACCC will not take into account counterfactuals it considers have been manipulated for the purposes of making clearance more likely. Signs that a counterfactual may have been manipulated include:

- a change of policy or intention by the merger parties that occurs after the merger is proposed
- any course of action by the merger parties which cannot be demonstrated to be profit maximising and/or in the interests of shareholders (for example, refusing to sell the business to a strong competitor if the proposed merger does not proceed).

Expected competition

3.20. The state of competition prevailing at the time of a merger will **understate** the future state of competition without the merger in situations where the merger parties are not presently constraining one another but would be likely to constrain one another in the foreseeable future. For example, the target firm may be on the verge of entering the relevant market or may already operate in the relevant market but be likely within the next one to two years to benefit from new technology or intellectual property that would enhance its competitiveness with the acquiring firm. Alternatively, if it can be established with strong and credible evidence that, in the absence of the merger, a particular alternative firm would acquire the target, the relevant counterfactual may involve a competitive outcome that differs from the status quo. The ACCC notes that such circumstances are likely to be rare.

17 See, for example, *Australian Gas Light Company (ACN 052 167 405) v Australian Competition and Consumer Commission* (No 3) [2003] FCA 1525, at [352].

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3.21. As specified in s. 4G of the Act, a lessening of competition includes preventing or hindering competition. Mergers likely to eliminate the prospect of more aggressive competition in the future may therefore result in a substantial lessening of competition.

The following are examples of the types of information the ACCC may require to assess whether the merger parties are likely to be effective competitors in the relevant market in the future:

- board papers and internal plans demonstrating that the target firm has the capability and intention to vigorously compete in the future
- evidence of vigorous entry in the past that may be replicated on a broader scale
- evidence of similar successful entry in other markets either in Australia or overseas.

The range and extent of information and documents required by the ACCC will be assessed on a case-by-case basis and will depend on the complexity of the matter and the potential competition concerns raised.

Failing firms

3.22. The state of competition prevailing at the time of a merger will overstate the future state of competition without the merger in situations where one of the merger parties is likely to exit the market in the foreseeable future (generally within one to two years). In such situations, the merger party that is likely to exit is referred to as a 'failing firm.' Although the likely state of competition with the merger may be substantially less than the state of competition prevailing at the time of the merger, the relevant test is whether the future state of competition with the merger would be substantially less than the future state of competition without the merger (where the firm fails).

3.23. Mere speculation that the target firm will exit in the near future or evidence of a recent decline in profitability is insufficient to establish that an absence of competition between the merger parties is the counterfactual. In general, to demonstrate that a merger will not substantially lessen competition due to the prospective failure of one of the merger parties, it is necessary to show that:

- the relevant firm is in imminent danger of failure and is unlikely to be successfully restructured without the merger
- in the absence of the merger, the assets associated with the relevant firm, including its brands, will leave the industry
- the likely state of competition with the merger would not be substantially less than the likely state of competition after the target has exited and the target's customers have moved their business to alternative sources of supply.

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4. Market definition

4.1. Section 50 of the Act requires that a substantial lessening of competition occur in a substantial market for goods and services in Australia, or a state, territory or region of Australia.[18] Accordingly, in assessing whether a merger substantially lessens competition, the ACCC will examine the competitive impact of the transaction in the context of the markets relevant to the merger.

4.2. Market definition establishes the relevant 'field of inquiry' for merger analysis, identifying those sellers and buyers that may potentially constrain the commercial decisions of the merger parties and the merged firm, and those participants, particularly customers, that may be affected if the merger lessens competition.

4.3. While market definition is a useful tool for merger analysis, by itself it cannot determine or establish a merger's impact on competition. Accordingly, market definition should not obscure factors relevant to competition that fall outside the relevant markets. Similarly, there is no presumption that other firms within a relevant market necessarily provide an effective competitive constraint on the merged firm. Other factors also relevant to merger analysis are outlined in chapters 5, 6 and 7.

4.4. It is rarely possible to draw a clear line around fields of rivalry. Indeed, it is often possible to determine a merger's likely impact on competition without precisely defining the boundaries of the relevant market. For example, if the consolidation of the merger parties' activities is unlikely to substantially lessen competition in a narrow product and geographic area, then it is also unlikely to do so in a more broadly defined product and geographic area and, therefore, a conclusive view on the relevant market may not be necessary. Similarly, when a merger is likely to substantially lessen competition in any number of potential markets, it may be unnecessary to define the precise market boundaries.

4.5. This chapter explains the concept of a market and the ACCC's approach to identifying and defining the scope of markets that are relevant to assessing a merger under s. 50 of the Act.

The concept of a market

4.6. A market is the product and geographic space in which rivalry and competition take place.

4.7. Section 4E of the Act provides that a market includes goods or services that are substitutable for, or otherwise competitive with, the goods or services under analysis. Accordingly, substitution is key to market definition.

4.8. The ACCC focuses on two key dimensions of substitution in characterising markets: the product dimension[19] and the geographic dimension. In some cases, market definition requires close attention to the functional levels of the supply chain that are relevant to a merger or the particular timeframe over which substitution possibilities should be assessed. Generally, however, these functional and temporal considerations form part of the product and geographic dimension analysis. Consistent with the forward-looking nature of merger analysis, the ACCC focuses on the foreseeable future when considering the likely product and geographic dimensions of a market.

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18 Section 50(6).

19 The term 'product' encompasses both goods and services for the purpose of discussion in these guidelines.

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4.9. Market definition is purposive, which means that the definition of a relevant market cannot be separated from the particular merger under investigation. Market definition always depends on the specific facts and circumstances of a merger, and current evidence from market participants will often be critical. Decisions relating to market definition in previous, albeit similar, merger inquiries will provide only limited guidance.

The ACCC approach to defining a market

4.10. The ACCC's starting point for delineating relevant markets to assess a merger under s. 50 of the Act is identifying the products and geographic regions actually or potentially supplied by the merger parties.[20] The ACCC then focuses on defining markets in areas of activity where competitive harm could occur. This must be assessed on a case-by-case basis. Generally, the ACCC focuses on overlaps between the products or geographic regions supplied by the merger parties, or some other meaningful economic relationship—such as an actual or potential vertical relationship or where the products supplied by the merger parties are complementary in nature. It is not uncommon for more than one market to be identified in any particular merger review.

4.11. The ACCC then considers what other products and geographic regions, if any, constitute relevant close substitutes in defining the market.[21] Importantly, the ACCC defines markets by reference to products and regions not by reference to the firms actually supplying those products or regions at the time of the merger.

Substitution

4.12. As outlined above, identifying relevant substitutes is key to defining a market. Substitution involves switching from one product to another in response to a change in the relative price, service or quality of two products (holding unchanged all other relevant factors, such as income, advertising or prices of third products). Market definition begins by selecting a product supplied by one or both of the merger parties in a particular geographic area and incrementally broadening the market to include the next closest substitute until all close substitutes for the initial product are included.

4.13. There are two types of substitution: demand-side substitution, which involves customer-switching; and supply-side substitution, which involves supplier-switching.

Demand-side substitution

4.14. Whether or not a product or region is a close substitute for a product supplied by one or more of the merger parties, depends on likely switching behaviour in response to an increase in the price, or decrease in the service or quality of that product. The likelihood that a product (or group of products) will be a **demand-side** substitute for a product of one of the merger parties will be assessed according to:

- the characteristics or functions of the product (the **product** dimension of a market). Comparable product characteristics and functionality will often be indicative but are not

20 There need not be trade in a product for a separate market to exist—the potential for exchange can be sufficient. See, for example, *Queensland Wire Industries Pty. Ltd v The Broken Hill Proprietary Company Limited & Anor* [1989] HCA 6; (1989) 167 CLR 177 F.C. 89/004; ATPR 40–925, Deane J at p. 50,013 (ATPR).

21 Note: there are some circumstances where the approach to market definition does not depend solely on the analysis of substitution possibilities. Some of these circumstances are discussed in paragraphs 4.41 to 4.44.

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sufficient to determine whether products are demand-side substitutes. Demand-side substitution depends on the willingness of customers to switch from one product to another in response to a price increase

- the availability of the product for purchase, and use, at the present location of the merger party's customers, or within a wider geographic area (the **geographic** dimension of a market). Demand-side substitution depends on the willingness of customers to switch from a product supplied in one location to the same product supplied in another location in response to a price increase.

4.15. It will often be possible on the demand-side, in some degree, to substitute a wide variety of products in various geographic regions for the products of the merger parties. Not all of these substitutes will be included in the relevant market. For instance, some customers might view seemingly remote products as substitutes under some circumstances. This simply illustrates that an economy is essentially 'a network of substitution possibilities'.[22]

4.16. On the other hand, substitution does not have to be complete or instantaneous, and products do not have to be 'perfect' substitutes to form part of the same market. To be included in the relevant market, the ACCC's view is that a product in a particular geographic region (or a group of products or regions) must be a close substitute in demand.

4.17. A product in a particular geographic region (or a group of products or regions) is a close demand-side substitute if a significant proportion of sales would be likely to switch in response to a small but significant increase in the price of the merger party's product, quickly and without significant switching costs. In cases where only a small proportion of sales is likely to switch, the ACCC's view is that the alternative product or geographic region (or group of alternative products or regions) is not part of the relevant market.

4.18. Qualitative and quantitative information may be requested from the merger parties and market participants to examine substitution possibilities. The ACCC draws on the conceptual framework provided by the hypothetical monopolist test (HMT) to define the relevant markets, particularly in relation to demand-side substitution.

The hypothetical monopolist test

4.19. The HMT determines the smallest area in product and geographic space within which a hypothetical current and future profit-maximising monopolist could effectively exercise market power. In general, the exercise of market power by the hypothetical monopolist is characterised by the imposition of a small but significant and non-transitory increase in price (SSNIP) above the price level that would prevail without the merger, assuming the terms of sale of all other products are held constant.

4.20. The process of applying the HMT starts with one of the products and geographic areas supplied by one or both of the merger parties. If a hypothetical monopolist supplier of this product cannot profitably institute a SSNIP because of customers switching to alternative products, the next closest demand substitute is added. If a hypothetical monopolist supplier of this extended group of products cannot profitably institute such a price increase because of customers switching to alternative products, the next best substitute is added. The collection of products is expanded until a hypothetical monopoly supplier of all those products could profitably institute a SSNIP.

22 *Re Tooth & Co. Ltd* (1978) ATPR 40-065, in *Re Tooheys Ltd* (1979), ATPR 40–113, at pp. 18,196–18,197.

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4.21. A SSNIP in the context of the HMT usually consists of a price rise for the foreseeable future of at least 5 per cent above the price level that would prevail without the merger.

4.22. While the HMT is a useful tool for analysis, it is rarely strictly applied to factual circumstances in a merger review because of its onerous data requirement. Consequently, the ACCC will generally take a qualitative approach to market definition, using the HMT as an 'intellectual aid to focus the exercise'.[23]

Supply-side substitution

4.23. In defining the product and geographic dimensions of the market the ACCC will also consider supply-side substitutes. A product (or group of products) may be a **supply-side** substitute for a product of one of the merger parties if in response to an increase in the price of the product:

- the production facilities and marketing efforts used for that product can be switched quickly and without significant investment to supply a demand-side substitute for the product of the merger party (the product dimension of the market)
- the distribution network used by the product can be modified quickly and without significant investment to supply the merger party's customers at their present location or within a distance they would likely travel (the geographic dimension of a market)
- it would be profitable for the current suppliers of the product to make these changes—that is, the profits earned on the assets in their current use would be less than if they were switched to supply a demand-side substitute for the product of the merger party.

4.24. The ACCC will treat one product as a supply-side substitute for another in cases where all (or virtually all) of the capacity for producing that product could profitably be switched to supply an effective substitute to the other product quickly and without significant investment in response to a price increase.

4.25. For some products, only a proportion of total supply capacity could feasibly be switched quickly and at minimal cost (for example, because firms producing this product use different technologies). In these cases, the capacity that could be switched will be considered as potential new entry when conducting the competition analysis rather than included in the market definition.

4.26. While a distinction is made between supply-side substitution and new entry for market definition purposes, the relevant consideration in establishing a substantial lessening of competition is the degree of competitive constraint imposed on the merged firm by either firms in the market or new entrants.

23 *Seven Network Limited v News Limited* [2007] FCA 1062, at [1786].

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Useful information in identifying demand-side and supply-side substitutes

4.27. The ACCC relies on information from the merger parties and third parties to identify and assess the strength of substitution possibilities.

Identifying products that may be close substitutes

The following are examples of the types of information the ACCC may require to identify close substitutes of the relevant product:

- the function or end use of the product
- physical and technical characteristics of the product
- costs of switching purchases between the product and potential substitutes
- views and past behaviour of buyers regarding the likelihood of substitution between products
- evidence of buyers switching to other products in response to price increases in the recent past
- evidence of producers redeploying their production capacity in response to price increases in the recent past
- costs of switching production and distribution systems from another product line to a product that is closely substitutable with the relevant product
- views, business records and past behaviour of suppliers of the relevant products regarding the impact of price and marketing decisions by suppliers of potential substitute products on their own pricing and marketing decisions
- relative price levels and price movements of the product compared to potential substitutes.

In an informal merger review, providing a base level of information to the ACCC will, in non-controversial cases, usually be sufficient to satisfy the ACCC of whether or not a substantial lessening of competition is likely. Whether a wider range of information will be required by the ACCC will be assessed on a case-by-case basis and will depend on the complexity of the matter and the potential competition concerns raised.

Identifying geographic regions that may be close substitutes

The following are examples of the types of information the ACCC may require to identify close substitutes of the relevant geographic region:

- the portability of the relevant product as determined by its perishability, weight, etc.
- transportation costs to move the relevant product between regions (particularly the transportation costs as a proportion of total value of the product)
- the costs to customers of obtaining supply from alternative regions
- any limitations on the ability of customers to access alternative sources of supply in alternative regions
- the costs of extending or switching production and distribution systems to supply the customers in alternative regions
- any regulatory or other practical constraints on suppliers selling to alternative regions
- records relating to trade flows and the actual movement of customers and/or suppliers between geographic regions, especially related to changes in relative prices across regions in the recent past
- views and business records of buyers and suppliers regarding the likelihood of switching between geographic sources of supply
- the relative price levels and price movements of different geographic sources of supply.

In an informal merger review, providing a base level of information will, in non-controversial cases, usually be sufficient to satisfy the ACCC of whether or not a substantial lessening of competition is likely. Whether a wider range of information will be required by the ACCC will be assessed on a case-by-case basis and will depend on the complexity of the matter and the potential competition concerns raised.

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Substantial market in Australia, a state, territory or region of Australia

4.28. Section 50(6) of the Act states that 'market' means a substantial market in Australia, or in a state, a territory or a region of Australia.

4.29. The ACCC's view is that the substantiality criteria could be satisfied in many ways including by reference to the size of the market in terms of number of customers, total sales or geographic size. A market that is 'small' in some sense may still be substantial.

4.30. In particular, substantiality of a market is not necessarily related to geographic size. A market may be small geographically (for example, a local market) but may also be substantial within the region in which it is located. Alternatively, a market for the supply of a product that is an essential but small ingredient in the production of one or more other products sold in large markets may be considered substantial.

4.31. Section 50(6) also states that 'market' means a market for goods or services in Australia, or in a state, a territory or region of Australia. In addition, s. 4E specifies that 'market' is a market in Australia. The ACCC's view is that this does not preclude it from analysing a merger proposal in the context of a geographically broader market—for example, a trans-Tasman market or even a global market—provided that at least some part of it is located in Australia.[24] In most cases the ACCC will define the relevant market to be Australia or a part of Australia, and take full account of any competitive constraint provided by suppliers located outside Australia when considering import competition (as required by the merger factors—see paragraphs 7.33 to 7.37).

Issues that may arise in market definition

Asymmetric substitution

4.32. Substitution possibilities are not necessarily symmetric. Asymmetric demand-side substitution occurs when substitution between two products only occurs in one direction. For example, buyers of luxury cars may substitute to more 'standard' cars in response to an increase in the price of luxury cars, but the opposite may not be the case. Asymmetric supply-side substitution may occur when one group of suppliers has the same production facilities as another group of suppliers, but also has additional facilities for supplying a slightly different good or service. For example, suppliers of scheduled travel services might be able to redeploy their facilities to provide charter travel services, but suppliers of charter travel services might face significant investment or obstacles to supply scheduled travel services (such as building terminal facilities).

Product differentiation

4.33. Market definition establishes the boundaries for competitive analysis but within those boundaries the degree of substitution can vary. Indeed it is extremely rare for a uniform level of substitution to exist across all products, services or regions within a relevant market. For example, products that serve similar functions may be differentiated rather than homogenous. Product differentiation often limits substitution at the margins because certain customers do not view differentiated products as comparable. For example, brand loyalty may limit the extent of both demand- and supply-side substitution. However, it is important to note that differentiated products may still be part of the same market.

24 See, for example, *Riverstone Computer Services Pty Limited v IBM Global Financing Australia Limited* [2002] FCA 1608, at [21].

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4.34. The extent to which product differentiation affects the constraint provided by actual or potential competitors in the market is taken into account when assessing the competitive effects of a merger (often by reference to different 'segments' of the market). While a substantial lessening of competition must arise in a market to contravene s. 50, this does not imply that the lessening of competition must apply to the entire market or to all aspects of competition in the relevant market.[25]

Discrimination and captive customers

4.35. In certain cases where substitution possibilities are not uniform across consumer groups, it may be appropriate to define separate markets for different consumer groups. For example, some consumers may view two products to be highly substitutable while other consumers may consider the products to be, at best, weak substitutes. In such situations, the relative number and importance of each customer class and the ability of suppliers (including the merger parties) to discriminate between the customer classes will be important when determining the appropriate product and/or geographic dimension of the market.

4.36. The ability of suppliers to discriminate between customer classes will depend on their ability to:

- distinguish between those customers that have the option of substitution and those who lack that option
- prevent resale or arbitrage between the customer classes.

4.37. If suppliers can discriminate, a customer that has limited substitution possibilities receives different terms and conditions from suppliers to a customer that has strong substitution possibilities. In this situation it may be appropriate to consider two separate markets for merger analysis. One market would include the relevant product and the alternative product, and would focus on those consumers who have the option of substitution. The second market would not include the alternative product and would focus on those consumers who are 'captive' or do not have the option of substitution.

4.38. If suppliers are unable to discriminate between customer classes, they will provide similar, if not identical, prices and levels of service to each customer, regardless of their substitution possibilities. In this situation, there are unlikely to be multiple markets based on different customer classes. Customers that are unable to substitute to the alternative product would be protected to the extent that suppliers cannot distinguish them from customers that are able to switch.

Indirect substitution

4.39. In some limited circumstances, a relevant market may include products that are only indirect substitutes for a product of one of the merger parties (that is, a substitute for a substitute of the relevant product). Indirect substitution occurs when there is a 'chain' of products in the product dimension or a 'chain' of regions in the geographic dimension. There are at least three significant limitations on the extent to which an indirect substitute can provide an alternative to the product or region under investigation and thereby be included in the relevant market:

- chains of substitution often have a break such that products on one side of the break are not close substitutes for those on the other side of the break (for example, breaks caused by obstacles to travel)

25 *Dandy Power Equipment Pty Ltd v Mercury Marine Pty Ltd* (1982) ATPR 40–315, at 43,888.

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- as a chain of substitution expands, the proportion of customers that can switch to neighbouring links in the chain (marginal customers) will tend to decrease and at some point a hypothetical monopolist controlling the chain would find a SSNIP profitable regardless of those switching customers
- where price discrimination is possible, a market may be limited to the captive customers at the centre of a chain or circle of substitution.

4.40. While analysis depends on the particular circumstances under examination, in general, the further removed from the product or region under investigation, the less likely it is that an indirect substitute will be included in the relevant market. The ACCC draws on whatever quantitative and qualitative information is available to determine the boundary of a market where chains of substitution exist.

Integration and aggregation[26]

4.41. The purposive nature of market definition can require the product or geographic dimension of a market to be extended beyond what can be substituted for products of the merger parties to include other **functional** levels in the vertical supply chain or other products that are typically purchased or supplied together with those of the merger parties.

4.42. Where merger parties are vertically integrated or compete against vertically integrated firms, the ACCC must determine whether competition analysis is best conducted in the context of one relevant market encompassing the whole vertical supply chain or a series of separate markets each comprising one or more stages of the chain. This delineation depends on the economics of integration. Importantly, there need not be trade between the relevant stages of the vertical supply chain for there to be separate markets—the potential for exchange can be sufficient.[27] However, where there are overwhelming efficiencies of vertical integration between two or more stages in the vertical supply chain, the ACCC will define one market encompassing all those stages.

4.43. To define the relevant markets where vertical integration exists, the ACCC considers, among other things:

- the actual patterns of exchange between firms at different vertical levels
- the split between internal transfers of each relevant product and third party transactions
- the costs involved in trading the product between firms at different vertical levels
- any obstacles to trade between firms at different vertical levels
- any assets or specialisation required to supply each product within the vertical chain.

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26 This includes considerations that have hitherto been categorised as the 'functional dimension' of the market. In practice, issues relating to integration and aggregation tend to inform the appropriate product and geographic characterisation of the market.

27 *Queensland Wire Industries Pty. Ltd. v The Broken Hill Proprietary Company Limited & Anor* [1989] HCA 6; (1989) 167 CLR 177 F.C. 89/004; ATPR 40–925, Deane J at p. 50,013(ATPR).

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4.44. In some cases, a product that the merger parties supply is part of a package of several distinct products that are generally purchased or supplied together. Such products may belong to several separate disaggregated markets and/or one aggregated market consisting of a suite of goods and services generally supplied together (sometimes referred to as a 'cluster market'). To define the relevant markets in these cases, the ACCC considers, among other things:

- the split between products purchased or supplied separately, and products purchased or supplied together
- the costs involved in purchasing or supplying the product separately
- any obstacles to purchasing or supplying the product separately
- any assets or specialisation required to supply each product.

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5. Unilateral effects

5.1. One of the main ways in which mergers can lessen competition is through unilateral effects. Mergers have unilateral effects when they remove or weaken competitive constraints in such a way that the merged firm's unilateral market power is increased. That is, as a result of the merger the merged firm finds it profitable to raise prices, reduce output or otherwise exercise market power it has gained, and can do so, even given the expected response of other market participants to the resulting change in market conditions.[28]

5.2. Where unilateral effects occur, other market participants' responses may vary. In some situations other market participants may respond in a pro-competitive way and (at least partially) attempt to offset the merged firm's behaviour. Alternatively, it may be more profitable for other market participants to simply support the merged firm's conduct—for example, if a merged firm exercises unilateral market power by raising the price of its products, other firms supplying substitutes may respond by also raising their prices, thereby exacerbating the competitive impact of the unilateral exercise of market power. As this example illustrates, a unilateral exercise of market power may make it profitable for both the merged firm and its competitors to raise prices.

5.3. In determining whether unilateral effects arise and whether they are likely to result in a substantial lessening of competition, the ACCC considers all of the merger factors contained in s. 50(3) of the Act and any other relevant factors. In particular, it considers whether the broader actual and potential competitive constraints—such as new entrants, imports or countervailing power—will limit any increase in the unilateral market power of each remaining market participant. These factors are discussed in more detail in chapter 7.

5.4. Although horizontal, vertical and conglomerate mergers can all potentially give rise to unilateral effects, it is recognised that vertical and conglomerate mergers are generally less likely than horizontal mergers to raise competition concerns. Since much of the general guidance on horizontal mergers is also relevant to vertical and conglomerate mergers, this section also identifies those competition issues that are specific to non-horizontal mergers that the ACCC will take into account. Mergers that involve both horizontal and non-horizontal effects will be assessed based on the combined horizontal and non-horizontal impact on competition.

Horizontal mergers

5.5. Horizontal mergers involve firms that operate in the same relevant market or markets. Horizontal mergers may give rise to unilateral effects by eliminating the actual or potential competitive constraint that the merger parties exerted on each other pre-merger. Two competing firms may constrain each other, including via the (actual or potential) transfer of sales from one to the other as customers switch, or threaten to switch, between them. If these two firms merge, the merger 'internalises' any such transfers within the merged firm, thereby removing this constraining effect. Where there are limited effective constraints from other sources, this unilateral effect can amount to a substantial lessening of competition.

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28 This may be contrasted to coordinated effects arising from a merger where it may be profitable for the merged firm to raise prices, reduce output or otherwise exercise market power because it considers that the responses of its rivals will be directly influenced by its own actions. This may manifest as either tacit or explicit collusion (see chapter 6).

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5.6. Unilateral effects may arise in different ways depending on the characteristics of the market—some, but not all are outlined below. The most obvious way is when no rivals[29] remain post-merger (i.e. merger to monopoly). In the absence of effective competitive constraints from other sources, such as future entrants, imports or countervailing power, a merger that leaves no rivals to the merged firm will likely result in unilateral effects amounting to a substantial lessening of competition.

5.7. Unilateral effects may also arise where a merger results in markets characterised by a single firm with market power and numerous other smaller competitors that can supply only a small portion of the total market demand because of factors limiting their ability to significantly expand output. In these circumstances, consideration will be given to whether the merged firm would have the ability and incentive to raise prices for the segment of the market that the smaller competitors are unable to supply—taking into account, amongst other factors, the ability and incentives of these smaller competitors to expand capacity.

5.8. In markets involving homogeneous products with no dominant firm, competition analysis will focus on the strategic interaction between rivals competing on output or capacity. Unilateral effects may arise where the merged firm sets its post-merger output level significantly below the level of output that would have prevailed absent the merger and, despite the response of competitors, brings about a higher price than would have prevailed absent the merger.

5.9. In contrast, in markets where competition between firms selling differentiated products is based on price, unilateral effects may arise where a merger between firms previously supplying close substitutes is able to increase the price of either or both of the close substitutes. In this case, consideration will be given to the proportion of substitution that would occur.

5.10. Outlined below are some of the relevant factors that the ACCC will take into account, in addition to those specified in s. 50(3) of the Act, to determine whether unilateral effects are likely to arise from a merger.

Significance of the merger parties to the competitive process

5.11. While some firms may be relatively small in terms of size and market share, they may nevertheless have a significant influence on the competitiveness of the market. Mergers involving such firms may result in unilateral effects by impeding or removing significant aspects of competition, such as innovation or product development.

Closeness of merger parties

5.12. The ACCC will take into consideration the extent of competitive constraint that the merger parties exert on each other pre-merger. Merger parties are more likely to be close competitors—and therefore provide each other with an effective constraint that may be lost post-merger—if they differ from rivals in respect of characteristics such as:

- product features and function
- customer loyalty
- production capacity
- breadth of product line and level of specialisation
- distribution channel coverage

29 In these guidelines, the term 'rival' includes both actual and potential rivals, unless the context otherwise specifies.

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- geographic presence
- cost structures
- level of vertical integration.

5.13. The degree of rivalry between the merger parties pre-merger can be an important factor in the analysis of mergers in differentiated product markets. Mergers between firms supplying competing differentiated products may result in unilateral effects when the merger parties are considered close competitors by a sufficient number of customers, which thereby alters the incentives of the merger parties. Merger parties are likely to have an incentive to increase the price of one or both products if the sales lost due to the price increase would be recaptured by an increase in sales of the other product. That is, the greater the number of customers that regard the merger parties as particularly close competitors (for example, their first and second choices), the greater the potential for the merger parties to impose a unilateral increase in price post-merger. Unilateral effects may arise even where the merger parties are not one another's 'closest' competitor pre-merger or would not be the dominant firm post-merger based on market shares.

5.14. Competitors supplying the relevant market with products that are less likely to be substituted for, or repositioned to compete with, the merger parties' products may only be able to offer a competitive alternative to marginal customers; the loss of such marginal customers would not prevent the merged firm's actions being profitable. Such competitors may also decide to simply follow the merged firm's price increase to profit from the less competitive environment.

Rivals' responses

5.15. Unilateral effects are unlikely if rivals have the incentive and ability to respond to a price increase by the merged firm such that they are able to capture sales and replace competition lost by the merger.

5.16. In some cases, rivals in differentiated product markets that are less direct competitors at the time of a merger may potentially overcome differences between themselves and the merged firm to become closer competitors. This may occur where rivals have the ability and incentive to reposition or extend their product range relatively easily and without significant cost in response to the merged firm increasing its prices. If the competition lost through the merger would likely be replaced by other rivals in the market or new entrants within a one- to two-year period, a merger is less likely to result in an increase in unilateral market power.

5.17. In non-differentiated product markets, other factors that may influence the abilities and incentives of rivals to constrain the merged firm from unilaterally increasing prices post-merger include whether:

- rival firms have sufficient capacity or are able to profitably expand capacity
- the merged firm is able to hinder entry or expansion by rivals through various means (for example, by controlling inputs, distribution channels and patents/other IP and access to, or pricing of, different platforms)
- the relevant products are sold under terms and conditions likely to limit or curtail the ability of rivals to compete effectively for the customers of the merged firm post-merger
- customers are constrained in their ability to switch to rival suppliers of the merged firm post-merger.

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Non-horizontal mergers

5.18. Non-horizontal mergers include vertical mergers and conglomerate mergers.

5.19. Vertical mergers involve combining firms that operate at different stages of a single vertical supply chain—that is, a merger between an 'upstream' firm and a 'downstream' firm (for example, an upstream manufacturer and a downstream distributor) where the upstream firm is an actual or potential supplier of an input into the production process of the downstream firm. It is often the case that vertical mergers will promote efficiency by combining complementary assets/services which may benefit consumers.

5.20. Conglomerate mergers involve firms that interact across several separate markets and supply products that are typically in some way related to each other—for example, products that are in neighbouring markets or products that are complementary in either demand or supply, such as staples and staplers.[30] Often, conglomerate mergers will allow firms to achieve efficiencies and result in better integration, increased convenience and reduced transaction costs.

5.21. In the majority of cases, non-horizontal mergers will raise no competition concerns. However, where insufficient competitive constraints remain in the relevant market post-merger, some non-horizontal mergers will raise competition concerns when the merged firm is able to increase its unilateral market power. One way in which this can occur is through the merged firm 'foreclosing' rivals, but non-horizontal mergers can also increase unilateral market power in other ways. In some cases, a non-horizontal transaction, either alone or in conjunction with a horizontal transaction, may amount to a substantial lessening of competition in a market.

Foreclosure

5.22. Recognising that not all forms of foreclosure are anti-competitive, the ACCC is only concerned with non-horizontal mergers where the merged firm has the ability and incentive to use its position in one market to anti-competitively foreclose rivals in another market in a way that lessens competition.

5.23. In determining whether foreclosure is likely to increase the unilateral market power of the merged firm, the ACCC will consider the following three issues:

- the merged firm's ability to foreclose
- any incentive the merged firm may have to foreclose
- the likely effect of any such foreclosure.

Vertical mergers

5.24. The particular anti-competitive foreclosure strategies that a vertically integrated merged firm might adopt will depend on the circumstances of each case, but some examples include:

- charging a higher price for an important input into the production processes of downstream (non-integrated) rivals
- limiting[31], or denying access by, downstream (non-integrated) rivals to important inputs (thereby forcing them, for example, to use more expensive or inferior quality alternatives)

30 Conglomerate mergers may also arise in markets that are unrelated or independent of one another.

31 Limiting access may involve reducing the quality of the good or service supplied.

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- limiting, or denying access by, upstream (non-integrated) rivals to a sufficient customer base
- raising the cost of access by upstream (non-integrated) rivals to a sufficient customer base.

Conglomerate mergers

5.25. Conglomerate mergers provide a merged firm with the opportunity to bundle or tie products in related or independent markets. The practice of bundling or tying product offerings is common and is undertaken by firms for a variety reasons, often with no anti-competitive consequences under s. 50.[32]

5.26. However, in some cases conglomerate mergers can raise competition concerns where they enable the merged firm to alter its operations or product offerings in a way that forecloses the merged firm's rivals and ultimately reduces the competitive constraint they provide. For example, the merged firm's rivals may be foreclosed if the merged firm chooses to bundle or tie complementary products, such that:

- no product can be purchased or used separately
- at least one product cannot be purchased or used separately, or
- customers receive additional benefits when they purchase or use the merged firm's products together (for example, due to discounts, rebates or design features).

5.27. The adoption of such strategies can limit or raise the cost of rival firms' access to a sufficient customer base and in some circumstances deny rival firms access to customers altogether.

Ability to foreclose

5.28. An integrated or conglomerate firm will generally only be able to engage in foreclosure if it has sufficient market power at one or more functional levels within the vertical supply chain, or in one or more of the related markets post-acquisition.

5.29. The ACCC will determine whether an integrated or conglomerate firm has market power in the relevant markets by assessing whether there are effective competitive constraints, such as those discussed in chapter 7.

Vertical mergers

5.30. An integrated merged firm would only be able to engage in foreclosure strategies against rival downstream firms if it had sufficient market power in the upstream market—that is, where its downstream rivals faced insufficient viable supply alternatives. This might occur for a variety of reasons including capacity constraints faced by rival upstream suppliers, barriers to entry or product differentiation between the products and/or services offered by the integrated firm and its rivals.

5.31. Similarly, an integrated merged firm would only be able to engage in foreclosure strategies against rival upstream firms if it had sufficient market power in the downstream market—that is, where its upstream rivals lacked sufficient actual or potential economic alternatives in the downstream market to sell their output. The ability of upstream rivals to sell their output is especially likely to be prevented or impeded where the downstream division of the merged firm is an important customer in that market and where there are significant economies of scale or scope in the input market.

32 Tying or bundling may however raise competition concerns under other provisions of the Act.

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Conglomerate mergers

5.32. In the context of conglomerate mergers, market power may arise where products are considered by customers to be especially important or a 'must have' because of factors such as superior functionality (product differentiation) or brand loyalty. Where the merged firm supplies customers that on-sell its products to end customers, the market power of the merged firm may be reflected in its ability to influence the product-stocking decisions of its customers. This will depend on the specifics of the industry, but can include supplier involvement in category management and the supply of in-store distribution assets to retailers on condition of certain stocking requirements.

Incentive to foreclose

5.33. While possession of market power by the merged firm in one or more of the relevant markets is a necessary consideration, it is not determinative in itself. Even if a vertically integrated or conglomerate firm has the ability, it may not have the economic incentive to foreclose rivals. A firm is unlikely to exercise its ability to foreclose unless it is profitable to do so, which will depend on the nature of competition in each of the relevant markets and the particular means available to the firm to foreclose rivals.[33]

5.34. An integrated or conglomerate firm will only have an incentive to engage in foreclosure strategies with rivals if the benefit it receives from doing so outweighs potential lost sales resulting from the foreclosure. In assessing whether the merged firm has the incentive to engage in foreclosure, the ACCC will weigh likely short-term costs against likely gains and the relative size and importance of each market to the merged firm.

5.35. For example, in vertical mergers foreclosing independent downstream rivals may simply close off a good source of upstream revenue without providing any significant boost to the integrated merged firm's own downstream sales or other benefits. Similarly, an integrated firm will only have an incentive to limit the downstream sales of its non-integrated upstream rivals if it receives sufficient benefits to offset any increased costs or decreased custom associated with the foreclosure.

5.36. In conglomerate mergers, the merged firm may be able to take advantage of economies of scale in a market by increasing sales in that market and, where there is commonality in operations (such as in manufacturing, distribution and/or marketing), may also be able to gain economies in a related market.

5.37. In assessing the merged firm's likely incentives, the ACCC will take into account a range of quantitative and qualitative information.

Likely effect of foreclosure

5.38. The ability and incentive of the merged firm to foreclose rivals may not of itself increase the merged firm's unilateral market power to the extent that there is a substantial lessening of competition. Consideration must also be given to the effect of foreclosure on competition in the relevant market/s.

5.39. Foreclosure need not result in rivals being forced to exit the market to have a detrimental effect on competition. Actual rivals may simply be forced to use more expensive alternatives to those

33 For example, a conglomerate firm implementing a tie may involve risking the loss of customers that are not interested in purchasing the bundle, depending on the closeness of the products in question. In addition, the profitability of discounting a bundle may depend on the relative value of the products being united and the value of the markets in which they are supplied.

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offered by the merged firm or may be discouraged from expanding their operations. Potential rivals may be discouraged from entering the market. Foreclosure lessens competition when the merged firm—and, in some cases, certain of its rivals—finds it profitable to increase the price charged to intermediate and end consumers or decrease the price paid to upstream suppliers below competitive levels.

5.40. In determining whether a merger is likely to result in a substantial lessening of competition, the ACCC considers all the merger factors contained in s. 50(3) of the Act and other relevant factors. In particular, the following factors inform the ACCC's assessment as to whether the merged firm's unilateral market power is likely to increase to the extent that there is a substantial lessening of competition:

- the proportion and significance of the firms that are foreclosed as a result of the merger
- the proportion and significance of other firms still able to provide a constraint over the merged firm
- the potential for the merger to raise barriers to entry by foreclosure or the threat of foreclosure to rivals in related markets.

5.41. Two further factors that may be relevant in the context of vertical mergers are:

- the significance of the input to the production process of downstream rivals
- the presence of countervailing power, particularly the ability of firms to integrate to avoid foreclosure.

5.42. An additional factor that may be relevant in the context of conglomerate mergers is the proportion of customers likely to purchase the relevant products from the merged firm. This must be sufficiently large to cause independent rivals to face a significant decline in sales, resulting in increased costs. The level of competitive constraint imposed by rivals may be detrimentally affected where economies of scale or network effects[34] are important features of the relevant markets, since foreclosure may prevent the merged firm's rivals from achieving minimum efficient scale.

5.43. However, where a significant proportion of customers continue to purchase products from independent rivals, a conglomerate firm is likely to continue to be constrained post-merger. For example, where rivals are able to replicate the merged firm's offering through assembly of their own competing bundle, and therefore reap similar cost savings and/or retain economies of scale or scope, they may be able to avoid or minimise foreclosure and thereby continue to constrain the merged firm. This may be through organic growth, counter-merger or joint supply arrangements with suppliers of the related product. Depending on the nature of the merged firm's market power, however, it may be difficult or impossible for rivals to replicate the merged firm's bundle. If rivals are able to avoid foreclosure by supplying a competitive bundle, a conglomerate merger is unlikely to substantially lessen competition.

Other unilateral effects

5.44. Other unilateral effects that may arise from vertical mergers and conglomerate mergers include raising structural and/or strategic barriers to entry and access to commercially sensitive information.

34 Network effects arise when a product becomes more valuable as the number of customers consuming it increases, thus providing an advantage to firms that have an existing customer base over rivals and prospective entrants that do not.

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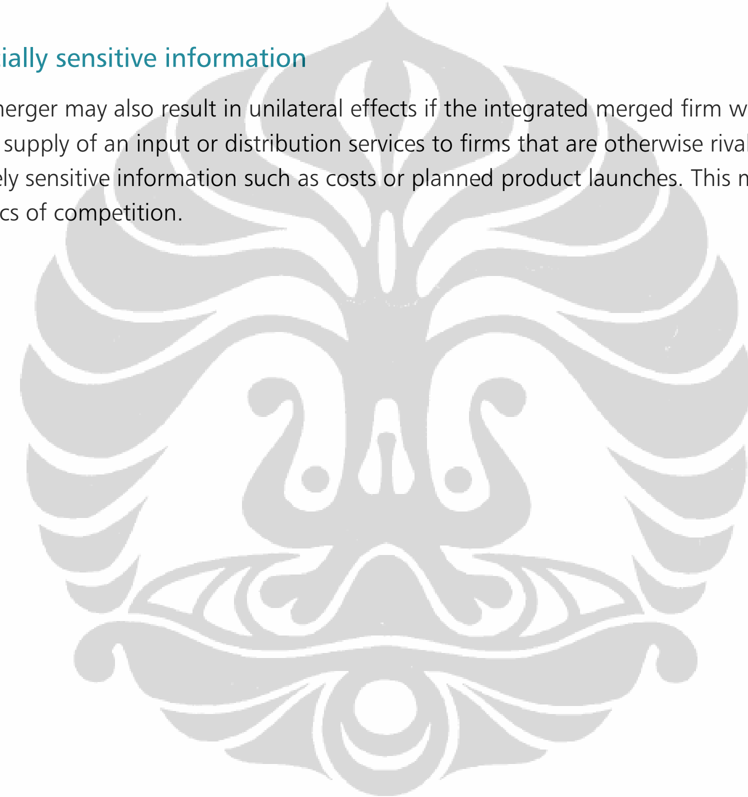
Barriers to entry

5.45. A vertical merger may raise barriers to entry if, as a result of the merger, new entrants would have to enter at multiple stages of the vertical supply chain instead of just one. In some cases, the increase in unilateral market power accruing to the merged firm as a result of increased barriers to entry constitutes a substantial lessening of competition.

5.46. By creating strategic links between related products, a conglomerate merger may result in formerly separate markets becoming part of one integrated market in which suppliers must offer the full range of complementary products to compete. Future entry may therefore require an offering of the full range of products, potentially increasing the sunk costs associated with entry or exit.

Access to commercially sensitive information

5.47. A vertical merger may also result in unilateral effects if the integrated merged firm would, through its supply of an input or distribution services to firms that are otherwise rivals, obtain competitively sensitive information such as costs or planned product launches. This may distort the dynamics of competition.



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6. Coordinated effects

6.1. In addition to unilateral effects, mergers can lessen competition through coordinated effects. Mergers have coordinated effects when they assist firms in the market in implicitly or explicitly coordinating their pricing, output or related commercial decisions. A merger may do so simply by reducing the number of firms among which to coordinate, by removing or weakening competitive constraints or by altering certain market conditions that make coordination more likely. Coordinated effects may occur in addition to unilateral effects so that the merged firm is able to achieve even higher prices than it would on its own. In some cases, coordinated effects, either alone or in conjunction with unilateral effects, may amount to a substantial lessening of competition.

6.2. Horizontal, vertical and conglomerate mergers may give rise to coordinated effects in a number of different ways. Some of these are discussed below, but coordinated effects may also arise in ways that are not discussed here. Competitive constraints and other factors relevant to coordinated effects are discussed in chapter 7. Rather than presenting horizontal, vertical and conglomerate mergers separately, this section discusses the issues that the ACCC considers relevant across all three types of merger.

Coordinated conduct

6.3. Mergers have coordinated effects when they alter the nature of interdependence between rivals such that coordinated conduct is more likely, more complete or more sustainable. Interdependence arises when a market is characterised by a small number of firms (an oligopoly or a duopoly), with each firm anticipating the response of the other firms and devising their commercial strategies accordingly. If the oligopolistic structure of a market persists over time—for instance, because barriers to entry and expansion shield incumbents from new competitors—the repeated nature of the competitive interaction can result in a range of coordinated conduct, from muted competition through to tacit or explicit agreement between firms not to compete. Although firms may have the ability to engage in effective competition, they may not have the incentive if they recognise that any short-term benefits from competing will likely be eroded by lost sales once other firms respond. Coordinated conduct can in some cases involve contravention of other provisions of the Act.

6.4. In some cases, a change in the nature of the interdependence among competitors may lead to an implicit agreement among them to refrain from competing. This behaviour is sometimes referred to as tacit collusion, since it involves active coordination but no explicit agreement between firms. Firms may signal to each other that they will not compete on price, output, customer allocation or indeed any other parameter of competition. Where the products are relatively homogenous, coordinated terms are more likely to be based on price or output in markets, whereas differentiated products may be more conducive to division of a market by customer type or region. In certain circumstances, interdependence may result in explicit collusion between firms, whereby firms explicitly agree to refrain from competing.

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Conditions facilitating coordinated conduct

6.5. When assessing whether a merger is likely to give rise to coordinated effects, the ACCC first assesses whether conditions in the relevant market are likely to be conducive to coordinated conduct. Generally, the potential for sustainable coordination is greatest where:

- firms have the ability and incentive to settle on terms[35] that are profitable for all
- firms can detect deviations from the consensus
- the threat of retaliation from other firms involved is sufficiently costly to act as a deterrent to deviation
- the consensus is not undermined by competitive constraints in the market (discussed further in chapter 7).

6.6. It is impossible to be prescriptive about the conditions in which coordinated conduct is likely to arise or the types of mergers that would increase the likelihood of coordinated conduct. However, settling on and maintaining a profitable consensus will often be easier where certain conditions exist post-merger. Some of these conditions are discussed below. The non-existence of one or more of these conditions may not necessarily make coordinated effects less likely and there may be other factors not discussed here which are relevant.

6.7. Importantly, a merger will only result in coordinated effects if it increases the likelihood of coordinated conduct, or it results in more complete or sustainable coordination post-merger. As noted above, a merger may do this by reducing the number of firms among which to coordinate (thereby reducing the likelihood of deviation from the consensus), by removing or weakening competitive constraints or by altering certain market conditions that make coordination more likely.

Observing other firms

6.8. Each firm must be aware of the behaviour of other firms for coordinated conduct to arise. This is easiest when the number of firms in the market is small (that is, concentration is high) and firms can quickly and readily observe other firms' activities and general market conditions. Information may be readily available if, for example, firms actively publish their prices to consumers, firms hold cross-shareholdings in each other, or trade associations collate and publish recent market information. Markets need not be fully transparent for coordinated conduct to arise, but firms must have some mechanism for detecting the behaviour of their competitors.

6.9. In addition, where product innovation or fluctuations in costs or demand are common, it may be difficult for firms to know whether a change in their rivals' pricing arises from such a fluctuation or constitutes a deviation from the settled terms. Market stability therefore facilitates coordination.

Retaliation and incentives

6.10. Coordinated effects are more likely when firms are likely to interact regularly post-merger, either in the relevant market where coordination could occur or in other separate markets, and for a considerable period. The sustainability of coordination rests upon repeated interaction, since the prospect of future retaliation discourages firms from pursuing more competitive strategies.

35 In these guidelines, 'settle on terms' and 'consensus' do not necessarily involve communication or active coordination but are intended to reflect muted competition, tacit collusion and explicit collusion.

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6.11. Firms in a market will have an incentive to deviate from the consensus unless they fear punishment that would outweigh the potential short-term gains from cheating on the terms of coordination. Punishment may simply involve a return to competitive conditions or, for example, a 'price war'. The incentive to cheat is increased if the imposition of punishment is likely to be significantly delayed (for example, because market transactions are infrequent). The credible threat of effective punishment alone may be sufficient to deter cheating.

6.12. The ability of coordinating firms to punish deviations is often increased where:

- firms have similar cost structures—low-cost firms may not fear retaliation by higher cost firms
- firms compete against each other in more than one market—this provides additional markets in which to punish deviating firms
- some firms have excess capacity, which enables them to increase output and reduce prices in response to a deviation from the terms of coordination.

6.13. Interdependence and coordination may therefore be facilitated by a merger that creates firms with similar market shares, cost structures, production capacities and levels of vertical integration. Where there is firm asymmetry, smaller firms or firms with lower cost structures may have more to gain from competing rather than refraining from competition. In this regard, a vigorous and effective competitor may be instrumental in disrupting interdependence and ensuring effective competition (see paragraph 7.56).

Competitive constraints

6.14. Coordination is unlikely to be sustained if it induces new entry or expansion by firms in the relevant market that are not engaging in coordination. Such competitive constraints are discussed further in chapter 7.

6.15. Generally, assessing whether a merger is likely to give rise to coordinated effects requires a close examination of the conditions prevailing in the relevant market and the likely effect of the merger on these conditions. This generally requires a detailed qualitative assessment of a range of factors (including those noted above), some of which may suggest conflicting conclusions. For example, a merger may decrease the number of firms in a market, while increasing the level of asymmetry between firms (or it might increase the level of symmetry). Given the potential complexity of the assessment required, evidence of prior coordinated conduct between firms in the relevant market may be highly relevant, particularly if the merger is likely to reduce the number of participants without undermining the conditions that facilitate coordinated conduct.

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7. Merger factors

7.1. Mergers result in unilateral and/or coordinated effects when they weaken or remove the competitive pressure on firms in a market. Where unilateral and/or coordinated effects amount to a significant and sustainable increase in the market power of the merged firm and/or other firms in a market, the merger is likely to substantially lessen competition in contravention of the Act.

7.2. In assessing whether a merger is likely to result in a significant and sustainable increase in market power, the ACCC must consider each of the merger factors set out in s. 50(3) as well as any other relevant factors (see paragraph 1.4). These merger factors provide insight about the likely competitive constraints that the merged firm will face post-merger. The merger factors cover a broad range of possible competitive constraints faced by the merged firm—some assist in identifying the presence of direct constraints[36], while others provide insight into less direct forms of constraint relating to either the structure and characteristics of the market[37] or the behaviour of actual and potential participants in the market.[38]

7.3. The ACCC recognises that competitive constraints are not static and strategic behaviour by market participants can affect competition. The significance of the merger factors and the weight placed on them will depend on the actual matter under investigation.

7.4. The likely presence of effective competitive constraints post-merger is a key indicator that a merger is unlikely to result in a substantial lessening of competition. While all the merger factors must be taken into consideration, it may not be necessary for all factors to indicate that the merged firm would face effective competitive constraints. In some cases a single constraint can be sufficient to prevent a significant and sustainable increase in the market power of the merged firm while in other cases the collective effect of several constraints may be required. Conversely, the absence of a single particular constraint is unlikely to be indicative of an increase in market power as a result of the merger.

7.5. The order in which the merger factors and other sources of constraint are considered below reflects the order in which the ACCC generally undertakes its analysis and does not reflect the priority or weight given to any particular factor. Indeed, many of the factors are interrelated and the ACCC adopts an integrated approach, taking into account all potential competitive constraints.

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36 For example, the level of actual and potential imports, height of barriers to entry, degree of countervailing power and the availability of substitutes.

37 For example, the dynamic characteristics of the market, level of concentration in the market and nature and extent of vertical integration.

38 For example, the likelihood that the acquirer would be able to significantly and sustainably increase prices or profit margins, whether the acquisition will result in the removal of a vigorous and effective competitor and other relevant factors.

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Concentration and market shares[39]

7.6. Market concentration refers to the number and size of participants in the market. It provides a snapshot of market structure as well as an approximation of the size of the merger parties, which can assist when considering the other merger factors. Changes in market concentration over time can also reveal the frequency of new entry and provide insight into the ability of new entrants and smaller competitors to attract custom and expand.

7.7. However, market concentration is not determinative in itself. For example, firms can gain a high market share by adopting more efficient technology, lowering costs and reducing prices. In such cases, high levels of market concentration are not necessarily reflective of a non-competitive market. Measures of concentration in markets characterised by product differentiation may also obscure the closeness of competitors.

7.8. Notwithstanding these limitations, market concentration can help to determine whether a merger is likely to result in unilateral and/or coordinated effects. It is the link between concentration and the strength of competition that is important for merger analysis and this ultimately requires consideration of all relevant factors before a final conclusion can be reached.

Measuring market concentration

7.9. The ACCC typically measures concentration with reference to market shares, concentration ratios and the Herfindahl-Hirschman Index (HHI).

Market shares

7.10. Market shares are a key input when determining concentration. The ACCC will generally calculate market shares according to sales, volume and capacity using information from a variety of sources, such as:

- the merger parties
- competitors
- customers
- suppliers
- trade associations
- market research reports.

7.11. Consistent with the forward-looking nature of the competition test, the ACCC considers the extent to which current market shares are likely to accurately reflect future market share patterns. For example, there may be evidence that substantial new capacity is due to come on-stream in a manufactured product market, new licences are about to be issued in a broadcasting market or some firms are running out of reserves in a primary product market. Where such evidence exists, the ACCC adapts current market shares accordingly.

39 Refers to the merger factor contained in s. 50(3)(c).

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Concentration and market shares

The ACCC will generally require information from the merger parties to calculate market shares based on the most appropriate measure from one of the following:

- sales by volume (for each competitor) in at least three recent annual periods
- sales by value (for each competitor) in those periods
- capacity (for each competitor) over the previous three years.

In some cases the ACCC may request additional information to calculate market shares based on an alternative measure to that provided by the merger parties. Whether a wider range of information will be required by the ACCC will be assessed on a case-by-case basis.

Market share information should be supported by details of how the data was compiled, the source of the estimates and any assumptions used. Where actual figures are not available, best estimates will be considered—for example, where there are a number of smaller firms in the market, an approximation may be appropriate.

In markets where actual or potential imports are relevant, these should be clearly identified (indicating whether these imports are independent of the merger parties) and included in the market share and concentration metric calculations. Similarly, supply-side substitutes should be included in these calculations.

Measures of concentration

7.12. In assessing market concentration, the ACCC takes into account the pre- and post-merger market shares of the merged firm and its rivals and the actual increase in concentration, as well as the level of symmetry between rival firms' market shares. Concentration metrics such as the HHI and the x-firm concentration ratio (CRx) may provide useful summary statistics by combining some or all of the market share data for individual firms. Different concentration metrics may highlight different aspects of the market share data.

7.13. The HHI is calculated by adding the sum of the squares of the post-merger market share of the merged firm and each rival firm in the relevant market, thereby giving greater weight to the market shares of the larger firms. The HHI therefore requires the market shares, or estimates of them, for all the participants in the relevant market. The HHI indicates the level of market concentration while the change in the HHI (or 'delta') reflects the change in market concentration as a result of the merger.

HHI threshold

7.14. As part of its overall assessment of a merger, the ACCC will take into account the HHI, as a preliminary indicator of the likelihood that the merger will raise competition concerns requiring more extensive analysis. The ACCC will generally be less likely to identify horizontal competition concerns when the post-merger HHI is:

- less than 2000, or
- greater than 2000 with a delta less than 100.

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7.15. These HHI levels should not be taken to imply a presumption as to whether or not a merger will be likely to result in a substantial lessening of competition. Only by considering the merger factors can this assessment be made. To illustrate this point, a merger that falls below the HHI threshold may still raise competition concerns if any of the following are relevant:

- a substantial number of customers consider the products of the merger parties to be particularly close substitutes—for example, the merger parties represent their first and second choices
- the target firm has shown a recent rapid increase in market share, has driven innovation or has tended to charge lower prices than its competitors in one or more markets (properly defined) in which the merged firm would operate.

7.16. The HHI threshold is not interchangeable with, or a substitute for, the notification threshold, (see chapter 2). Mergers that meet the notification threshold should be notified to the ACCC regardless of the specific HHI and delta.

Height of barriers to entry[40]

7.17. The entry of new firms into a market can provide an important source of competitive constraint on incumbents. If new entrants are able to offer customers an appropriate alternative source of supply at the right time, any attempt by incumbents to exercise market power will be unsustainable since their customers will simply switch to the new entrants. A credible threat of new entry alone may prevent any attempt to exercise market power in the first place.

7.18. If there is a high likelihood of timely and sufficient entry in all relevant markets post-merger, the merged firm is unlikely to have market power either pre- or post-merger and therefore the merger is unlikely to result in a substantial lessening of competition. In some markets, however, there are barriers to entry that either prevent firms from entering the market altogether or delay and impede entry to such a degree that the merged firm is sheltered from competitive constraint for a significant period.[41] A barrier to entry is any factor that prevents or hinders effective new entry that would otherwise be capable of defeating a price increase caused by a merger.[42]

7.19. The ACCC takes the view that new entry must be timely, likely and sufficient in scope and nature to be effective. This test will be based on an assessment of the height of barriers to entry taking into account whether actual or threatened entry post-merger is both possible and likely in response to an attempted exercise of market power by the merged firm—this will generally depend on the profitability of entering the market.

7.20. It is not necessary for a merger to increase barriers to entry for it to be anti-competitive—only that significant barriers exist and provide the merged firm with discretion over its pricing and other conduct. If the merger also increases barriers to entry, the effect on competition is likely to be more severe because new entry that may have been possible before the merger is likely to be prevented or impeded post-merger—that is, the gap between the future states with and without the merger will be widened.

40 Refers to the merger factor contained in s. 50(3)(b).

41 The analysis would apply in matters involving unilateral effects and also matters involving coordinated effects (in particular the possibility of new entry constraining the ability and incentive of a small group of firms to engage in coordinated conduct).

42 Note that some barriers to entry may technically be barriers to **exit**. Nevertheless, the effect is the same if such barriers to exit increase the risk to prospective entrants and ultimately discourage entry.

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Timeliness of entry

7.21. When considering the degree of competitive constraint provided by new entry, it is necessary to assess the time it would take a new firm to enter the relevant market and offer customers a competitive alternative to the merged firm. The evaluation of whether entry will be timely necessarily varies with each specific merger and the dynamics of the market.

7.22. Entry will generally provide an effective competitive constraint post-merger if actual or threatened entry would occur in an appropriate time to deter or defeat any non-transitory exercise of increased market power by the merged firm. While the ACCC's starting point for timely entry is entry within one to two years, the appropriate timeframe will depend on the particular market under consideration.

7.23. When determining whether potential entry is likely to be timely the ACCC considers the barriers outlined in paragraphs 7.30 to 7.32, as well as factors such as the frequency of transactions, the nature and duration of contracts between buyers and sellers, lead times for production and the time required to achieve the necessary scale.

Likelihood of entry

7.24. The ACCC needs to be satisfied that actual or threatened entry post-merger is not just possible but likely in response to an attempted exercise of market power by the merged firm. The likelihood of entry generally depends on the profitability of entering the market. The ACCC will assess whether a new entrant could expect to make a commercial return on its investment taking into account the price effects the additional output may have on the market and the likely responses of the incumbent firms and other costs/risks associated with entry.

7.25. Factors likely to affect the profitability of entry include the examples of barriers outlined in paragraphs 7.30 to 7.32. Evidence of the past success or failure of new entrants in establishing themselves as effective competitors in the relevant market may also provide insight into the profitability of entry into particular markets but will not necessarily indicate ease of entry. To test the likelihood of entry where it is not possible to identify potential new entrants, the ACCC requires identification of the likely categories of entrants that could potentially enter.

Sufficiency of entry

7.26. Entry must be of sufficient scale with a sufficient range of products to provide an effective competitive constraint. In differentiated product markets, the sufficiency of entry will critically depend on the ability and incentive[43] of entrants to supply a sufficiently close substitute to that of the merged firm. Entry at the fringe of the market is unlikely to constrain any attempted exercise of market power by incumbents if incumbents are unlikely to lose significant sales to those fringe entrants. Therefore individual entry that is small-scale, localised or targeted at niche segments is unlikely to be an effective constraint post-merger.

7.27. Sufficiency does not require in all circumstances that one new entrant alone duplicates the scale and all the relevant activities of the merged firm. Timely entry by multiple firms may be sufficient if the combined effect of their entry would defeat or deter the exercise of increased market power by the merged firm.

43 The ACCC will take into account a range of factors including whether new entry that targets the products of the merged firm would be profitable.

Analisis penetapan..., Utami Pudjiastuti, FE UI, 2010.

7.28. The ACCC's assessment of the timeliness, likelihood and sufficiency of entry will depend on the circumstances of each particular merger under consideration. However, the underlying test is always whether the potential for entry provides an effective competitive constraint that would prevent a significant and sustainable increase in the market power of market participants post-merger.

Types of barriers to entry

7.29. In assessing the potential for entry to act as a competitive constraint, the ACCC considers the costs of entry and incumbency advantages under the following categories:

7.30. **Legal or regulatory barriers**, including but not limited to:

- licensing conditions, tariffs, explicit restrictions on the number of market participants and other government regulations
- legally enforceable intellectual property rights
- environmental regulations that raise the costs of entry or limit the ability for customers to switch suppliers.

7.31. **Structural or technological barriers**, including but not limited to:

- the existence of sunk costs, which increase the risks of, and costs associated with, failed entry and include factors such as product development, advertising or promotion to establish a sufficient reputation in the market and construction of specialised facilities—the high risk and costs associated with failed entry may deter new entry
- substantial economies of scale, which may limit the viability of entry below a certain minimum efficient scale
- high customer switching costs, such as search costs, transaction costs and market specific behaviour (including customer inertia to switching suppliers)
- mature markets or markets with declining levels of demand growth
- access to key production or supply assets, important technologies or distribution channels
- the existence of significant network effects.

7.32. **Strategic barriers** that arise because of actions or threatened actions by incumbents to deter new entry, including but not limited to:

- risk of retaliatory action by incumbents against new entry, such as price wars or temporarily pricing below cost
- creation and maintenance of excess capacity by incumbents that can be deployed against new entry
- creation of strategic customer switching costs through contracting, such as exclusive long-term contracts and termination fees
- brand proliferation by incumbents, which may crowd out the product space leaving insufficient opportunities for new firms to recover any sunk entry costs.

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Height of barriers to entry

The following are examples of the types of information the ACCC may require to assess the height of any barriers to entry:

- the ability of producers that are not current competitors to switch production to competing products or services
- the market conditions that may affect the ability of existing firms to expand
- the size and extent of any investment, particularly sunk investment, that producers would need to make to either enter the relevant market/s or to expand production significantly in these market/s
- the extent of brand loyalty in the relevant market/s
- the existence and nature of any long-term supply contracts in the relevant market/s
- any relevant 'switching costs' (such as product compatibility issues, product bundling, contract termination charges) that may prevent buyers in the relevant market/s from changing suppliers or sellers in the relevant market/s from changing buyers, in the short to medium term
- evidence of any growth or decline in the relevant market/s.

In an informal merger review, providing a base level of information to the ACCC will, in non-controversial cases, usually be sufficient to satisfy the ACCC of whether or not a substantial lessening of competition is likely. Whether a wider range of information will be required by the ACCC will be assessed on a case-by-case basis and will depend on the complexity of the matter and the potential competition concerns raised.

Actual and potential import competition[44]

7.33. Actual or potential direct competition from imported goods or services can provide an important competitive discipline on domestic firms. Where the ACCC can be satisfied that import competition—or the potential for import competition—provides an effective constraint on domestic suppliers, it is unlikely that a merger would result in a substantial lessening of competition.

7.34. While the current or historic levels of imports may indicate the competitive role of imports in the relevant market, the ACCC will consider the potential for imports to expand if the merged firm[45] attempted to exercise increased market power post-merger.

7.35. Imports are most likely to provide an effective and direct competitive constraint in circumstances where all of the following conditions are met:

- independent imports (that is, imports distributed by parties that are independent of the merger parties) represent at least 10 per cent of total sales in each of the previous three years
- there are no barriers to the quantity of independent imports rapidly increasing that would prevent suppliers of the imported product from competing effectively against the merged firm within a period of one to two years (for example, government regulations, the likelihood and impact of anti-dumping applications on imports, customer-switching costs or the need to establish or expand distribution networks)

44 Refers to the merger factor contained in s. 50(3)(a).

45 The analysis would apply in matters involving unilateral effects and also matters involving coordinated effects (in particular the possibility of import competition constraining the ability and incentive of a small number of firms to engage in coordinated conduct).

Analisis penetapan..., Utami Pudjiastuti, FE UI, 2010.

- the (actual or potential) imported product is a strong substitute in all respects (that is, quality, range, price, etc.) for the relevant product of the merged firm, taking into account factors including the need to meet any relevant Australian or industry standards, any increase in the complexity of customers' logistical arrangements, increased transport times and costs, and the risk of adverse currency exchange rate fluctuations
- the price of actual or potential landed imports, including any tariffs or other import-specific taxes and charges, (that is, the import parity price) is close to the domestic price of the relevant product that would prevail in the absence of the merger
- importers are able to readily increase the supply volume of the product they import with minimal or no increase in the price paid
- the merged firm and other major domestic suppliers do not have a direct interest in, are not controlled by, and do not otherwise interact with, actual or potential import suppliers.

Barriers to import expansion

7.36. The ability of imports to expand (import supply elasticity) will be a key consideration in the ACCC's competition analysis. If the supply of imports is either unable to respond, or only able to respond slowly, to an increase in demand by Australian consumers, imports are unlikely to effectively counteract any increased market power of the merged firm. For example, where there are production capacity or supply constraints, or where imports targeted to niche segments would not be profitable on a wider scale given their cost structures, import competition is unlikely to be sufficient to prevent a substantial lessening of competition.

7.37. The barriers to import expansion that the ACCC considers when assessing the supply elasticity of imports include:

- the existence of capacity constraints overseas and the resulting impact on the potential for expansion of imports into Australia
- the level and impact of transport costs and logistics (particularly the impact of transport costs as a percentage of the value of the good or service being imported)
- the cost and delay associated with the need to establish or expand effective distribution networks
- the cost and delay associated with any specialised facilities required by importers to supply domestic customers
- the level and effect of tariffs, quotas and other government regulations (both in Australia and the country of origin)
- the likelihood and impact of anti-dumping applications on imports
- the presence of exclusive licensing arrangements on imports
- the existence of impediments to customers choosing imports rather than the domestic product post-merger, such as switching costs, lock-in contracts, compatibility problems, importance of an Australian agent and local service and supply, or consistency and timeliness of supply.

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Actual and potential import competition

The following are examples of the types of information the ACCC may require to determine the competitive constraint provided by imports:

- which products are imported into the relevant market/s
- who undertakes the importation and their relative share of the market/s
- estimates of the actual and potential level of import competition in the market/s
- historical importation figures
- details of any barriers to entry to importing, including access to distribution facilities, transport costs and customs restrictions
- details of the price of imports as opposed to domestic production in the relevant market/s and an explanation of any divergence in these prices
- the extent to which imports provide a constraint on domestic suppliers, including the merger parties, in the relevant market/s post-merger.

In an informal merger review, providing a base level of information to the ACCC will, in non-controversial cases, usually be sufficient to satisfy the ACCC of whether or not a substantial lessening of competition is likely. Whether a wider range of information will be required by the ACCC will be assessed on a case-by-case basis and will depend on the complexity of the matter and the potential competition concerns raised.

Availability of substitutes[46]

7.38. In assessing the competitive implications of a merger, the ACCC considers both the range of available or potentially available substitutes in each relevant market and the relative intensity of rivalry between different products within those markets. The existence of comparable alternatives to the merged firm that are available in plentiful supply to the entire market can, in the absence of coordinated effects, indicate that a merger is unlikely to substantially lessen competition.

7.39. The analysis of the likely competitive constraints provided by alternatives focuses on two issues:

- rivalry within the market, given the likely closeness of rivalry between the merger parties and between the merged firm and its rivals
- barriers to expansion (elasticity of supply).

Rivalry within the market

7.40. When analysing the competitive effects of a merger, the ACCC assesses the closeness of rivalry between the merger parties and between the merger parties and other market participants. This analysis goes beyond the process of defining the market based on whether products are close substitutes—it also considers the relative degree of substitution or rivalry between alternative suppliers of products in the relevant market and the merged firm.

46 Refers to the merger factor contained in s. 50(3)(f).

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7.41. As discussed in chapter 5, unilateral effects in differentiated product markets are more likely if the merger parties are relatively close competitors pre-merger and other market participants, while providing alternatives to consumers, are relatively more distant competitors for the products of the merged firm. The ACCC therefore considers the extent of product differentiation by assessing whether the merger parties differ from rivals in terms of:

- product features and function
- customer loyalty
- brand loyalty
- whether a substantial number of customers consider the products of the merger parties to be particularly close substitutes—for example, the merger parties represent their first and second choices
- production capacity
- breadth of product line and level of specialisation
- distribution channel coverage
- geographic presence
- cost structures
- the level of vertical integration.

7.42. If, for a significant number of customers, the merger parties are each other's closest competitor and there would be no close competitors to the merged firm in one or more relevant markets, the ACCC then explores the ability and incentives of rivals in the relevant market/s to move into the merged firm's product or geographic space post-merger. This analysis involves considering any barriers to mobility across the product or geographic space within a market and taking into account relevant factors such as those listed below in the context of barriers to expansion. Impediments may include the costs of altering the mix of products, the costs of introducing a new type of product, brand loyalty to the relevant products, the profitability of entry targeting the products of the merged firm or the costs of establishing or expanding distribution channels for the relevant types of product.

7.43. Conversely, if the merger parties are relatively distant competitors in the relevant market pre-merger, and several of the merged firm's remaining rivals would be close competitors to the merged firm, the merger is less likely to result in a substantial lessening of competition in that market.

Barriers to expansion

7.44. The degree of competitive constraint provided by rivals to the merged firm also depends on their ability to profitably increase production in the event that the merged firm attempts to exercise market power (the elasticity of supply).[47] The ability of rivals to expand depends on the existence of any features of the market that either prevent firms from expanding altogether or delay or impede expansion to such a degree that rivals are unable to expand in an appropriate time to defer or defeat any non-transitory exercise of increased market power by the merged firm. While the ACCC's starting point for timely expansion is within one to two years, the appropriate timeframe will depend on the particular matter under consideration. For example,

47 The analysis would apply in matters involving unilateral effects and also matters involving coordinated effects (in particular the possibility of smaller rivals expanding production in response to coordinated conduct).

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the appropriate timeframe may be longer than one to two years in industries where supply arrangements are subject to long-term contracts.

7.45. The abilities and incentives of the merged firm's rivals to increase output and sales if the merged firm attempts to exercise increased market power post-merger depend on, among other things:

- the level of excess capacity that non-merger parties could deploy to take sales away from the merged firm
- the cost to non-merger parties of expanding their output
- the ability of non-merger parties to source increased inputs and their ability to distribute increased output to customers
- the level of excess capacity held by the merged firm that could be deployed to prevent non-merger parties from capturing sales.

7.46. The ACCC will consider similar factors to those set out in paragraphs 7.30 to 7.32 in relation to new entry. For example, if non-merger parties face difficulties in distributing increased output because of logistical bottlenecks, the availability of substitutes may be limited post-merger. However, the costs of expansion can sometimes differ significantly from the costs of new entry.

7.47. If non-merger parties are capacity constrained post-merger, they will have a reduced ability to steal customers from the merged firm if it attempts to exercise market power. As a result, if non-merger parties in the relevant market are capacity constrained, the merger is more likely to result in a substantial lessening of competition.

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The availability of substitutes

The following are examples of the types of information the ACCC may require to assess the relative degree of rivalry both between the merger parties themselves and between the merger parties and other market participants:

- internal company strategy, marketing and sales documents
- information about advertising campaigns and other information that highlights how firms in the market perceive the competitive constraint created by other market participants
- past history of customers switching between suppliers
- whether market features exist that prevent or hinder customers changing suppliers—for example, switching costs resulting from the use of exclusive long-term contracts and termination fees
- studies and information regarding consumer preferences
- estimates of cross elasticities of supply and demand[i]
- the diversion ratios between the merger parties[ii]
- estimates of the own-price elasticity of supply of non-merger parties[iii]
- the production capacity of firms in the market, including any capacity constraints or excess capacity
- the costs to rival firms of expanding their output
- impediments to firms altering or expanding their product mix to compete more closely with the products of the merged firm
- whether the merged firm controls inputs/distribution channels, patents/other IP and access to, or pricing of, different platforms
- the degree of homogeneity of products.

In an informal merger review, providing a base level of information to the ACCC will, in non-controversial cases, usually be sufficient to satisfy the ACCC of whether or not a substantial lessening of competition is likely. Whether a wider range of information will be required by the ACCC will be assessed on a case-by-case basis and will depend on the complexity of the matter and the potential competition concerns raised.

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i The cross-elasticity of supply (demand) is the percentage change in the supply (demand) for one firm's output in response to a 1 per cent change in the price of the product sold by a second firm.

ii A diversion ratio measures the proportion of consumers that switch to another firm's product if a particular firm increases the price of its product.

iii The own-price elasticity of supply of a firm is the percentage change in the firm's output in response to a 1 per cent change in the price the firm sells its product for.

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Countervailing power[48]

7.48. In addition to considering supply-side sources of competitive constraint, the ACCC also considers whether one or more buyers would have sufficient countervailing power to constrain any attempted increase in market power by a supplier.[49] Countervailing power exists when buyers have special characteristics that enable them to credibly threaten to bypass the merged firm[50], such as by vertically integrating into the upstream market, establishing importing operations or sponsoring new entry.

7.49. Countervailing power is more than the ability of buyers to switch to alternative domestic or imported products. As discussed above, the availability of substitutes and import competition are important considerations in assessing whether a merger is likely to result in a substantial lessening of competition. The availability of effective alternatives to the merged firm provides all buyers with a means of bypassing the merged firm. Countervailing power, however, exists when the specific characteristics of a buyer—such as its size, its commercial significance to suppliers or the manner in which it purchases from suppliers—provide the buyer with additional negotiating leverage. In some cases, a buyer may have countervailing power because they have market power.[51]

7.50. Importantly, the size and commercial significance of customers (sometimes referred to as 'buyer power') is not sufficient to constitute countervailing power. A large buyer that accounts for a significant proportion of the merged firm's sales may be able to negotiate favourable terms and price relative to other buyers in the market. However, buyers need more than size to constrain the exercise of market power by a supplier. For example, if the supplier's product is an essential input for the buyer, the only way the buyer can defeat any attempted increase in market power is if it can credibly threaten to bypass the supplier.

7.51. In assessing whether countervailing power is likely to prevent a substantial lessening of competition by constraining any attempt by the merged firm to increase market power, the ACCC considers the following factors, among others:

- **Whether the threat to bypass is credible on commercial grounds**
  Evidence of this will often include the size of the buyer's purchases and the efficient scale of production of the product. For sponsored entry to be commercially viable, the entrant will have to operate at an efficient scale of production. If the purchases of the sponsoring firm are insufficient to underpin such a production scale, the ACCC needs to be convinced that the entrant could readily find other sales in the relevant market.

48 Refers to the merger factor contained in s. 50(3)(d).

49 In a merger between buyers, countervailing power may also be exerted by one or more suppliers if they are able to bypass the merged firm and establish alternative supply channels. In line with the approach adopted throughout these guidelines, consideration is directed towards the case where the merged firm is a seller in the relevant market under analysis. As previously noted, all guidance provided here needs to be appropriately adjusted when merger analysis involves a merger of competing purchasers.

50 The analysis would apply in matters involving unilateral effects and also matters involving coordinated effects (in particular the possibility of countervailing power constraining the ability and incentive of a small number of firms to engage in coordinated conduct).

51 The existence of buyer market power may offset the merged firm's market power on the supply side (see the Trade Practices Legislation Amendment Bill 1992, explanatory memorandum, paragraph 23). However, the ACCC notes that the outcomes of mergers that 'pit' market power against market power are difficult to determine. When firms in both markets have market power, a broad range of prices and price structures are possible and there is a risk that the merger will result in monopoly prices being charged for both the input (in the upstream market) and the final output (in the downstream market). Such a 'double-monopoly' can be particularly damaging to consumers.

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- **Whether the buyer is likely to bypass the supplier**
  Evidence of this could include plans or other documents suggesting such a strategy is commercial, as well as instances and circumstances when the buyer or other buyers of the relevant input have previously sponsored entry or vertically integrated. The ACCC places greater weight on evidence that such strategies form part of the firm's business model. Also, if the relevant input does not account for a significant proportion of the buyer's total input costs, sponsored entry or backward integration may be less likely.

- **The proportion of the downstream market able to wield a credible threat**
  For the countervailing power to offset or limit any market power arising from a merger, it will usually not be sufficient if only one buyer or category of customers is able to bypass the merged firm post-merger. For example, the merged firm may be able to increase prices charged to smaller buyers that are unable to bypass the supplier while larger buyers with countervailing power are able to avoid the increase. A significant proportion of customers must be shielded from the effects of market power if countervailing power is to prevent a substantial lessening of competition in the relevant market/s.

Countervailing power

The following are examples of the types of information the ACCC may require to ascertain the degree of countervailing power in the relevant market/s:

- the relative strength of bargaining power possessed by customers of the products in the relevant market/s
- the extent to which it is possible for customers to bypass the merger parties by importing or producing the product themselves, vertically integrating, or using an alternative supplier.

In an informal merger review, providing a base level of information to the ACCC will, in non-controversial cases, usually be sufficient to satisfy the ACCC of whether or not a substantial lessening of competition is likely. Whether a wider range of information will be required by the ACCC will be assessed on a case-by-case basis and will depend on the complexity of the matter and the potential competition concerns raised.

Dynamic characteristics of the market[52]

7.52. The forward-looking nature of merger analysis means that the ACCC, when analysing the competitive effect of a merger, must take into account the changing nature of the market in the future. Dynamic changes may result from a range of factors including market growth, innovation, product differentiation and technological changes. The analysis of the effects of dynamic changes in the market is closely linked with analysis of the other merger factors discussed in this chapter. The changes in the market will be considered from two perspectives:

- the extent to which the dynamic features of the market affect the likely competitive impact of the merger
- whether the merger itself impacts on the dynamic features of the market.

7.53. Whether a market is growing or declining can have significant implications for the competitiveness of the market in the future. Markets that are growing rapidly may offer both greater scope for new entry and the erosion of market shares over time. Similarly, markets that are characterised by rapid product innovation may be unstable so that any increased market power gained through a merger is transitory.

52 Refers to the merger factor contained in s. 50(3)(g).

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7.54. In general, a merger is less likely to substantially lessen competition in a market that is rapidly evolving.

7.55. When considering how a merger will influence future competition in a dynamic market, the ACCC places more weight on robust evidence about likely future developments in the relevant market. The ACCC will give significantly less weight to predictions about the future state of competition that are speculative or have little chance of developing for some considerable time in the future.

Dynamic characteristics of the market

The ACCC may require information on dynamic characteristics such as growth, innovation and product and/or service differentiation. In an informal merger review, providing a base level of information to the ACCC will, in non-controversial cases, usually be sufficient to satisfy the ACCC of whether or not a substantial lessening of competition is likely. Whether a wider range of information will be required by the ACCC will be assessed on a case-by-case basis and will depend on the complexity of the matter and the potential competition concerns raised.

Removal of a vigorous and effective competitor[53]

7.56. Mergers involving a vigorous and effective competitor (sometimes referred to as a maverick firm) are more likely to result in a significant and sustainable increase in the unilateral market power of the merged firm or increase the ability and incentive of a small number of firms to engage in coordinated conduct. Vigorous and effective competitors may drive significant aspects of competition, such as pricing, innovation or product development, even though their own market share may be modest. These firms tend to be less predictable in their behaviour and deliver benefits to consumers beyond their own immediate supply, by forcing other market participants to deliver better and cheaper products. They also tend to undermine attempts to coordinate the exercise of market power.

7.57. A merger that removes a vigorous and effective competitor may therefore remove one of the most effective competitive constraints on market participants and thereby result in a substantial lessening of competition.

Removal of a vigorous and effective competitor

The following are examples of the types of information the ACCC may require to ascertain the extent to which each party to the transaction would separately be considered as a vigorous and effective competitor in the relevant market/s:

- evidence of past competitive pricing behaviour, for example discounting and promotions
- levels of point-of-sale service (for example opening hours and store format) and after-sales service
- past and expected innovation, for example in design or production technology
- past evidence of leadership in non-price competition, for example product quality and loyalty programs.

In an informal merger review, providing a base level of information to the ACCC will, in non-controversial cases, usually be sufficient to satisfy the ACCC of whether or not a substantial lessening of competition is likely. Whether a wider range of information will be required by the ACCC will be assessed on a case-by-case basis and will depend on the complexity of the matter and the potential competition concerns raised.

53 Refers to the merger factor contained in s. 50(3)(h).

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Vertical integration[54]

7.58. It is recognised that some horizontal mergers can be affected by vertical integration or vertical relationships in the market—for example, horizontal competition issues may be exacerbated by vertical aspects of a merger and vice versa. Where a merger involves both horizontal and vertical competition issues, the ACCC will assess the merger based on the combined horizontal and vertical impact on competition.

7.59. The nature and extent of vertical relationships between firms in separate areas of activity along a vertical supply chain can affect the competitive implications of consolidation in any one of those areas. For example, a horizontal merger can increase the likelihood of coordination in cases where downstream integration increases the visibility of pricing. Generally, horizontal mergers involving a vertically integrated firm are unlikely to lessen competition provided effective competition remains at all levels of the vertical supply chain post-merger.

Vertical integration

The following are examples of the types of information the ACCC may require to ascertain whether vertical integration is likely to be relevant to the competition assessment:

- whether the merger will result in vertical integration between firms involved at different functional levels of the relevant market/s
- whether the merger is likely to increase the risk of limiting the supply of inputs or access to distribution, such that downstream or upstream rivals face higher costs post-merger or risks of full or partial foreclosure of key inputs or distribution channels
- the extent of existing vertical integration, noting in particular where either merger party currently operates as a customer or supplier to competitors in the relevant market/s.

In an informal merger review, providing a base level of information to the ACCC will, in non-controversial cases, usually be sufficient to satisfy the ACCC of whether or not a substantial lessening of competition is likely. Whether a wider range of information will be required by the ACCC will be assessed on a case-by-case basis and will depend on the complexity of the matter and the potential competition concerns raised.

Ability to increase prices or profit margins[55]

7.60. As discussed in paragraph 3.5, a merger that results in the merged firm[56] being able to significantly and sustainably increase prices (or exercise market power in other non-price ways) will substantially lessen competition. In general, an increase in price will result in a corresponding increase in profit margins. In some cases, the merged firm's ability to significantly and sustainably increase profit margins may also indicate a substantial lessening of competition. For example, following a vertical merger that achieves control over essential inputs, the merged firm may be able to raise the prices at which it sells to competitors in intermediate markets, thereby increasing its revenue and accordingly its profit margins, while raising the input costs of its competitors above its own.[57] However, several factors influence profit margins and the ACCC recognises that increased profitability may not be a conclusive indicator of a substantial lessening of competition. Assessing the likelihood of a significant and sustainable increase in prices or profit margins requires an analysis of all sources of competitive constraint.

54 Refers to the merger factor contained in s. 50(3)(i).

55 Refers to the merger factor contained in s. 50(3)(e).

56 The analysis would apply in matters involving unilateral effects and also matters involving coordinated effects (in particular whether a small number of firms could significantly and sustainably increase prices post-merger

57 Trade Practices Legislation Amendment Bill 1992, explanatory memorandum, paragraph 26.

Analisis penetapan..., Utami Pudjiastuti, FE UI, 2010.

7.61. The ACCC considers both qualitative and quantitative evidence relating to the likelihood that the merger will lead to a significant and sustainable increase in prices or profit margins. Qualitative evidence may include relevant internal firm documents, industry studies and other information provided by market participants, including the merging parties.

Ability to increase prices or profit margins

The following are examples of the types of information the ACCC may require to determine the extent to which merger parties may be able to increase prices or profit margins:

- details of recent and current levels of pricing in the relevant market/s, including the use of rebates and discounts
- details of supply costs of goods and services supplied by the merger parties including manufacturing, marketing and distribution costs in the relevant market/s
- a description of any competitive constraints likely to prevent the merger parties from significantly and sustainably increasing the prices paid by their customers, or lowering the prices paid to their suppliers post-merger in the relevant market/s
- a description of the likely effect of the merger on the profit margins of the merger parties post-merger and the expected cause of any change.

In an informal merger review, providing a base level of information to the ACCC will, in non-controversial cases, usually be sufficient to satisfy the ACCC of whether or not a substantial lessening of competition is likely. Whether a wider range of information will be required by the ACCC will be assessed on a case-by-case basis and will depend on the complexity of the matter and the potential competition concerns raised.nd on the complexity of the matter and the potential competition concerns raised.

Other factors

7.62. The list of merger factors contained in s. 50(3) is not exhaustive. Particular mergers may involve other factors that affect the likely competitive outcome of the merger. It is not possible in these guidelines to foresee every possible factor that may be relevant in a particular merger assessment, but other factors such as merger-related efficiencies, effect of export markets and government regulation may be relevant.

Efficiencies

7.63. The potential for improved efficiency is a common motivation for firms to merge. Merger-related efficiencies include greater economies of scale and scope from combining production, distribution and marketing activities, greater innovation yields from combining investment in research and development and reduced transaction costs.[58] The ACCC recognises that a reduction in marginal costs post-merger may increase competitive tension. However, the ACCC's focus in s. 50 merger analyses is the effect of the merger on competition, competitive constraints and the efficiency of markets, rather than the efficiency of individual firms. A merger that removes or weakens competitive constraints to the extent that a substantial lessening of competition results, will (unless authorised) contravene s. 50—even if the merger results in a more efficient firm with a lower cost structure.

58 Larger firms also typically achieve lower input prices because of enhanced bargaining power and bulk discounts. Such cost reductions are pecuniary benefits, not efficiency gains. In some cases a merger of two significant acquirers of an input can substantially lessen competition for the acquisition of that input. The ACCC will explore such issues separately from the impact of efficiencies on competitive constraints in the relevant supply market.

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7.64. While competitive constraints are generally external to a firm, the likely internal cost structure of a firm (which, for a merged firm, is in part determined by the efficiencies it has gained through merging) is often relevant to competition. For instance, the cost structure of firms in a duopoly or oligopoly market is one of many factors relevant to the likelihood of coordinated conduct. Symmetry between firms may be conducive to coordinated conduct and strategic interdependence, whereas the presence of a firm with a lower cost structure than that of its rivals might cause coordination to break down. Similarly, changes in the level of excess capacity in a market may alter the intensity of competition. The competitive impact of a merged firm's likely cost structure depends on the circumstances of the merger.

7.65. If efficiencies are likely to result in lower (or not significantly higher) prices, increased output and/or higher quality goods or services, the merger may not substantially lessen competition. The ACCC generally only considers merger-related efficiencies to be relevant to s. 50 merger analyses when it involves a significant reduction in the marginal production cost of the merged firm and there is clear and compelling evidence that the resulting efficiencies directly affect the level of competition in a market and these efficiencies will not be dissipated post-merger.

7.66. In cases where a merger is likely to achieve significant efficiencies, but the efficiencies do not prevent a substantial lessening of competition, the merger may only proceed if authorised by the Tribunal. The Tribunal may consider whether gains in efficiency constitute a public benefit that outweighs the public detriment from the substantial lessening of competition.

Potential effect of exports on domestic markets

7.67. While competition in overseas markets may prevent the merged firm from raising its export prices, the ACCC generally focuses on whether the merged firm[59] is able to significantly and sustainably raise prices in a market in Australia post-merger.[60] Generally, the merged firm's export operations do not limit its ability to exercise market power in a market in Australia. In some limited circumstances, however, exports can play a similar role in constraining the market power of domestic suppliers to the role played by imports in constraining the market power of domestic suppliers.

7.68. The merged firm may be constrained in its domestic activities by competition in export markets if:

- the merged firm's foreign sales (exports) represent a significant proportion of the merged firm's total sales and
- the merged firm is unable to discriminate in price (or other characteristics) between foreign and domestic sales.

7.69. Under these circumstances, the merged firm may be limited in its ability to exercise market power in the relevant market in Australia without losing export sales. Any increased profit from the domestic market may be offset by the fall in profits from export sales.

59 Either unilaterally or in conjunction with other suppliers.

60 Exports may provide a competitive constraint when a merger involves firms that are buyers in the relevant market. In line with the approach adopted throughout these guidelines, consideration is directed towards the case where the merged firm is a seller in the relevant market under analysis. As previously noted, all guidance provided here needs to be appropriately adjusted when merger analysis involves a merger of competing purchasers.

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Government regulation

7.70. The ACCC considers the effect of any state or federal government regulation that affects competition. For example, firms may be restricted in the range or features of products they can supply, or a price cap might prevent increases in price. However, the ACCC does not regard speculation about future alterations to the regulatory environment, or the mere ability of government to regulate, as an effective competitive constraint.

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Appendix 1: Relevant provisions of the Act

1. The merger and acquisition provisions are part of the competition provisions of Part IV of the Act. Some of the relevant provisions of the Act are summarised below for ease of reading. However, the Act is complex legislation and, while the ACCC believes such summaries are accurate, the nature of the Act requires the actual provisions to be consulted in specific cases.

The substantive mergers test (s. 50)

2. Section 50 of the Act prohibits acquisitions that would have the effect, or be likely to have the effect, of substantially lessening competition in a substantial market in Australia or a state, territory or region of Australia.

3. Section 50 of the Act provides that:

(1) A corporation must not directly or indirectly:

(a) acquire shares in the capital of a body corporate, or

(b) acquire assets of a person

if the acquisition would have the effect, or be likely to have the effect, of substantially lessening competition in a market.

(2) A person must not directly or indirectly:

(a) acquire shares in the capital of a corporation, or

(b) acquire any assets of a corporation

if the acquisition would have the effect, or be likely to have the effect, of substantially lessening competition in a market.

(3) Without limiting the matters that may be taken into account for the purposes of subsections (1) and (2) in determining whether the acquisition would have the effect, or be likely to have the effect, of substantially lessening competition in a market, the following matters must be taken into account:

(a) the actual and potential level of import competition in the market

(b) the height of barriers to entry to the market

(c) the level of concentration in the market

(d) the degree of countervailing power in the market

(e) the likelihood that the acquisition would result in the acquirer being able to significantly and sustainably increase prices or profit margins

(f) the extent to which substitutes are available in the market or are likely to be available in the market

(g) the dynamic characteristics of the market, including growth, innovation and product differentiation

(h) the likelihood that the acquisition would result in the removal from the market of a vigorous and effective competitor

(i) the nature and extent of vertical integration in the market.

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4. Foreign acquisitions for which an acquirer is not considered to be carrying on a business within Australia may fall under s. 50A of the Act for consideration.

5. Section 4G provides:

> For the purposes of this Act, references to the lessening of competition shall be read as including references to preventing or hindering competition.

6. Section 4E of the Act provides:

> For the purposes of this Act, unless the contrary intention appears, market' means a market in Australia and, when used in relation to any goods or services, includes a market for those goods or services and other goods or services that are substitutable for, or otherwise competitive with, the first mentioned goods or services.

7. Sections 50 and 50A relate only to substantial markets for goods and services in Australia, a state, a territory or a region (ss. 50(6) and 50A(9)).

8. The terms 'substantial lessening of competition', 'market' and 'substantial market' are discussed in paragraphs 3.5, 4.6 and 4.28 respectively.

Clearance processes and authorisations provisions

9. The ACCC investigates and reviews those mergers it becomes aware of that have the potential to raise concerns under s. 50 of the Act. The ACCC's approach to informal merger reviews is contained in its *Merger review process guidelines* (available at www.accc.gov.au/mergers).

10. Alternatively, parties may seek to apply to the ACCC for a formal clearance of a proposed merger. In such cases, the clearance process is governed by ss. 95AC to 95AS of the Act.

11. Sections 95AC to 95AS of the Act provide for the ACCC, upon application by the acquirer, to grant formal clearance for a proposed merger on the basis that it would not have the effect, or be likely to have the effect, of substantially lessening competition (within the meaning of s. 50). Further details about the ACCC's consideration of applications for formal clearance may be found in the ACCC's Formal merger review process guidelines (available at www.accc.gov.au/mergers). If formal clearance is granted, the merger parties will be protected from legal action under s. 50 (s. 95AC).

12. Sections 95AT to 95AZM of the Act allow application to be made to the Tribunal for authorisation on the basis that the merger would result, or is likely to result, in such a benefit to the public that it should be allowed to take place. If authorisation is granted, the merger parties will be protected from legal action under s. 50 (s. 95AT).

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Enforcement and undertakings provisions

13. Under s. 87B of the Act, the ACCC may accept a written undertaking in connection with a matter in relation to which it has a power or function under the Act, except Part X. If the undertaking is breached, the ACCC may seek orders from the court directing compliance with the undertaking, the giving up of any financial benefit gained from the breach, compensation for any other loss or damage as a result of the breach, or any other appropriate orders. Section 87B provides:

    (1) The ACCC may accept a written undertaking given by a person for the purposes of this section in connection with a matter in relation to which the ACCC has a power or function under this Act (other than Part X).

    (2) The person may withdraw or vary the undertaking at any time, but only with the consent of the ACCC.

    (3) If the ACCC considers that the person who gave the undertaking has breached any of its terms, the ACCC may apply to the court for an order under subsection (4).

    (4) If the court is satisfied that the person has breached a term of the undertaking, the court may make all or any of the following orders:

        (a) an order directing the person to comply with that term of the undertaking;

        (b) an order directing the person to pay to the Commonwealth an amount up to the amount of any financial benefit that the person has obtained directly or indirectly and that is reasonably attributable to the breach;

        (c) any order that the court considers appropriate directing the person to compensate any other person who has suffered loss or damage as a result of the breach;

        (d) any other order that the court considers appropriate.

14. Under s. 80 of the Act, only the ACCC may seek injunctive relief from the Federal Court to prevent a merger from proceeding (s. 80(1A)). Other persons may institute declaration proceedings in respect of an acquisition (s. 163A) but may not seek an injunction.

15. Under s. 81 (1) of the Act, the court may, on the application of the ACCC or any other person, if it finds or has in another proceeding under the Act found that a person has contravened s. 50, give directions to secure disposal of all or any of the shares or assets acquired in contravention of s. 50. Under s. 81(1A) the court may declare such an acquisition void where it finds that the vendor was involved in the contravention. Section 81(1C) provides for the court to accept as an alternative an undertaking from the person to dispose of other shares or assets owned by the person. An application under s. 81(1) or 81(1A) may be made at any time within three years after the date on which the contravention occurred.

16. In certain circumstances, as provided for in ss. 76(1A) and 76(1B) of the Act, the court may impose a penalty for a contravention of s. 50 of up to $500 000 for an individual and, for a corporation, up to the greatest of:

    - $10 million
    - three times the value of the benefit to the corporation that is reasonably attributable to the contravention
    - 10 per cent of the corporation's annual turnover.

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17. In summary, the provisions of the Act relevant to mergers include:

- mergers and acquisitions—s. 50
- extraterritorial operation—s. 5(1)
- overseas share acquisitions—s. 50A
- anti-competitive agreements—s. 45
- definition of acquisition of shares or assets—s. 4(4)
- market definition—s. 4E
- lessening of competition includes preventing or hindering—s. 4G
- determination of an application for formal clearance—ss. 95AC to 95AS
- determination of an application for authorisation—ss. 95AT to 95AZM
- injunctions—s. 80
- divestiture and setting aside acquisitions—s. 81
- pecuniary penalty—s. 76
- enforceable undertakings—s. 87B.

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Appendix 2: Acquisitions subject to the Act

1. The following provides guidance about the types of transactions that are subject to the Act. Nevertheless, the Act is complex legislation, and parties should consult the actual provisions of the Act to determine whether a particular transaction falls within the scope of the Act.

Territorial jurisdiction

2. The Act applies to the following acquisitions:

   (a) acquisitions of property within Australia are covered by virtue of s. 50, including (but not limited to):

   - shares in Australian companies, wherever the transaction is entered into, as the shares are domestically situated
   - domestic businesses
   - local intellectual property such as trademarks
   - local plant and equipment.

   (b) acquisitions of property wherever situated are covered by virtue of ss. 50 and 5(1) if the acquirer is:

   - incorporated in Australia
   - carries on business in Australia
   - an Australian citizen, or
   - ordinarily resident in Australia.

   (c) if (a) and (b) above do not apply, acquisitions of a controlling interest (presumably shares in almost all cases) in a body corporate where that body corporate has a controlling interest in a corporation are covered by virtue of s. 50A.

Acquirers subject to the Act

3. Section 50 of the Act applies to corporations (s. 50(1)) and persons (s. 50(2)).

4. Acquisitions involving both incorporated and non-incorporated entities are subject to the Act through Part XIA (the Competition Code). Each Australian state and territory government has, under clause 5 of the Conduct Code Agreement between the Australian Government and state and territory governments, passed legislation implementing the Competition Code.

5. The merger provisions of the Act also apply to the Commonwealth and to the state and territory governments insofar as they are carrying on business (ss. 2A and 2B respectively). Pecuniary penalties do not, however, apply to activities of the Crown.

Types of acquisitions

6. The Act applies to both direct and indirect acquisitions. Section 4(1) of the Act makes it clear that ‘acquire’ is not limited to acquisition by way of purchase but also includes exchange, lease, hire or hire purchase.

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7. Section 4(4) of the Act provides that joint acquisitions and acquisitions of equitable as well as legal interests are acquisitions subject to s. 50[61], but that in the case of assets, an acquisition by way of a charge and an acquisition in the ordinary course of business are not acquisitions to which s. 50 applies.

Exceptions

8. Section 51(1) of the Act provides for exceptions from s. 50 and s. 50A for conduct that is specified in and specifically authorised by Commonwealth legislation. As with all exceptions under s. 51, the relevant Commonwealth law must specify the excepted acquisition and specifically authorise it (s. 51(1)(a)(i)). Acquisitions cannot be exempted from s. 50 and s. 50A by state or territory laws (s. 51(1C)(b)).

Partial shareholdings and minority interests

9. Mergers often involve one or more firms being completely subsumed by another firm. However, mergers and acquisitions may also involve parties acquiring a partial shareholding in another firm. There is no threshold shareholding for the purposes of s. 50 and all acquisitions are therefore subject to the Act.

10. For the purposes of competition analysis, acquisition by one company of a controlling interest in another company will be treated in the same way as an acquisition of all the shares of the target company. While a majority shareholding would in many cases ensure control, much lower shareholdings with or without other non-shareholding interests might also be sufficient. Factors that the ACCC takes into account when considering whether a shareholding and/or other interest is sufficient to deliver control of a company include, among other things:

- the ownership distribution of the remaining shares and securities, including ordinary and preference shares and any special shares
- the distribution of voting rights, including any special voting rights
- whether other shareholders are active or passive participants at company meetings
- any restrictive covenants or special benefits attaching to shares
- any pre-emption rights in relation to the sale of shares or assets
- any other contracts or arrangements between the parties
- the rights and influence of any significant debt holders
- the composition of the board of directors
- the company's constitution.

11. In any event, a level of ownership less than a controlling interest that nevertheless alters the incentives of all parties may give rise to a contravention of s. 50 of the Act. The Act does not refer to control but rather to the effect on competition. The following are some of the potential anti-competitive effects of shareholdings below a level delivering control:

- horizontal acquisitions may increase interdependence between rivals and lead to muted competition or coordinated conduct (see chapter 6)

61 In *Trade Practices Commission v Arnotts Ltd & Ors* (1990) ATPR 41–002, at 51,044, creation of an option over shares was found to create an equitable interest in those shares and therefore constituted an acquisition subject to s. 50.

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- joint acquisitions of assets by rivals may have coordinated effects
- vertical or conglomerate acquisitions may increase the acquirer's incentive to foreclose rival suppliers
- acquisitions may provide access to commercially sensitive information in relation to competitors
- acquisitions may block potentially pro-competitive mergers and rationalisation.

Horizontal minority acquisitions

12. If a firm has a significant shareholding in a rival firm, it may be less inclined to compete head-to-head with that firm, since to do so would result in a transfer of revenue between commonly held assets and would likely reduce overall profitability. Refraining from competition to maximise joint profits becomes more attractive. Where the incentives lie in particular circumstances depends on the relative value of the assets as well as the percentage shareholding. Partial shareholdings and directorships may result in coordinated effects by reducing the incentives for 'cheating', making departures from the consensus harder to conceal and facilitating the exchange of information between firms.

Third party minority acquisitions

13. Two parties that compete in one market may acquire shares in a company or participate in a joint venture in another market. This may result in coordinated effects in the first market.

14. Minority interests may raise competition concerns when the same party has an interest in a number of otherwise independent competitors. For example, if a party acquires a minority interest in two competitors, that acquisition may substantially lessen competition if it results in coordinated effects. Such coordination need not be explicit but may simply reflect the mutual benefits to be gained by the relevant firms in limiting competition, together with the requirement for each competitor's directors to act in the interests of the company as a whole. In such circumstances, the ACCC may also consider whether overlapping directorships create opportunities to limit competition between rivals.

Vertical minority acquisitions

15. Minority interests may also raise competition concerns when the same party has an interest in vertically related firms or firms supplying complementary products. If an acquisition creates a relationship between a firm with significant market power in one market and another firm operating in a market upstream or downstream, the acquisition may create an incentive for the firm with market power to discriminate in favour of the related firm.

16. In addition to analysing the effect that the acquisition of the minority interest will have on the incentives of the relevant firms, the ACCC will take into consideration the legal responsibilities of company directors under the *Corporations Act 2001* and at common law.

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Minority acquisitions and information flows

17. Firms could gain access to commercially sensitive information about their rivals through either horizontal or vertical acquisitions. Debt holders may also have access to significant information. Information such as costs, revenues, bids, contracts, forward supply estimates, marketing campaigns and new product plans may be available. The level of available information depends on the nature and level of the shareholding. If the shareholding is sufficient to secure a position on the board of directors, more information is likely to be available.

Blocking stakes

18. A shareholding of over 10 per cent in a company is sufficient to block the compulsory acquisition of all the shares by another party. This in turn may allow the minority shareholder to prevent rationalisation of two weak rivals and the creation of a more competitive firm, thereby hindering or preventing competition.

ACCC's assessment

19. The framework for competition analysis set out in these guidelines is relevant for all share acquisitions, whether or not they deliver control of the target firm. Where share acquisitions do not deliver control, the ACCC will take into consideration inter-company relationships, director's duties, and a range of other factors including:

    - the actual ownership share of the minority interest
    - the existence of any contractual or other arrangements that may enhance the influence of the minority interest
    - the size, concentration, dispersion and rights of the remaining ownership shares
    - the board representation and voting rights of the minority interests.

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Appendix 3: Undertakings

1. During the course of its competition assessment, the ACCC may identify competition concerns that support the view that an acquisition is likely to substantially lessen competition in contravention of the Act. If these competition concerns cannot be resolved and the merger parties continue to pursue the acquisition, the ACCC will, along with other orders, seek an injunction in the Federal Court to stop the merger proceeding.

2. In some cases, however, merger parties can provide the ACCC with a court enforceable undertaking under s. 87B of the Act to implement structural, behavioural or other measures that assuage the competition concerns identified by the ACCC.[62] Undertakings of this type are also referred to as 'remedies.' If the ACCC is satisfied that the proposed measures will address the competition concerns identified, it may accept the undertaking and allow the merger to proceed. Merger parties therefore have strong incentives for proposing effective and enforceable remedies in the form of s. 87B undertakings to remedy identified competition concerns.

3. Undertakings that remedy a likely contravention of the Act prevent the detriment that would otherwise result from the transaction, while at the same time allowing any benefits arising from the transaction to be realised. In the merger context, undertakings can address the competition concerns while at the same time permitting the realisation of merger benefits, such as efficiencies or improvements in management. In this context, s. 87B undertakings are a flexible alternative to simply opposing an acquisition when the ACCC believes that a merger or acquisition is likely to substantially lessen competition.

4. The provision of undertakings is at the discretion of the party giving the undertaking. The structure and content of undertakings offered to the ACCC will therefore be a matter for the party offering the undertaking to determine. However, the ACCC will not accept undertakings if it is not satisfied they address its competition concerns. The ACCC encourages merger parties to carefully consider ACCC feedback on the form and content of proposed undertakings.

General principles

5. The ACCC's approach to the substance of s. 87B undertakings will depend on the merits and circumstances of each matter. However, it is possible to identify certain general principles that underpin effective undertakings.

6. In accepting an undertaking the ACCC does not seek to improve competition beyond the pre-merger level of competition, but the remedy needs to adequately address the potential harm identified. There will be instances when only an outright rejection of the merger can address the ACCC's competition concerns.

7. To determine whether the undertaking is acceptable, the ACCC will consider a range of factors—in particular the effectiveness of the remedy to address the ACCC's competition concerns, how difficult the proposal will be to administer, the ability of the merged firm to deliver the required outcomes, monitoring and compliance costs and any risk to competition associated with the implementation of the undertaking (or failure to do so).

62 In some circumstances, the ACCC may seek an undertaking from merger parties not to proceed until the ACCC has completed an informal merger review. This is distinct from the enforceable undertakings under discussion in this appendix 3.

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8. Before accepting an undertaking, the ACCC will need to be satisfied that:

- the proposed undertaking is customised to the particular nature of the relevant merger, the competition concerns raised, and the industry or industries involved
- the core obligations in the proposed undertaking (for example, a divesture) specifically, comprehensively and effectively address the ACCC's competition concerns
- the proposed undertaking would impose clear and unambiguous obligations on the party giving the undertaking, including clear delineation of assets and businesses covered by the remedy, the terms under which the remedy is to be carried out, timeframes for actions to be completed, and the consequences of non-performance within those timeframes
- the party offering the undertaking is capable of meeting its obligations as set out in the undertaking, and the remedy cannot be frustrated by the actions (or inaction) of third parties (for example, there may be matters where minority shareholders remain following the acquisition of a firm, who may be able to prevent the acquirer from meeting its obligations under a proposed undertaking)
- for international mergers involving firms operating in jurisdictions other than Australia, any remedies provided to the ACCC are capable of being enforced by the ACCC and coordinated with any of the other relevant jurisdictions involved.

9. Importantly, the ACCC will be unlikely to accept an undertaking when, in its view:

- there are risks that the undertaking will not be effective in preventing a substantial lessening of competition as a result of the merger, and/or
- there are risks that the undertaking cannot be implemented in practice and (where necessary) properly monitored and/or enforced.

Types of undertakings

10. Undertaking remedies are conventionally classified as either structural or behavioural. Structural remedies generally change the structure of the merged firm and/or the market, typically through divestiture of part or all of a business, and, in satisfying the ACCC's competition concerns, are generally aimed at restoring or maintaining the level of competition prevailing before the acquisition. Behavioural remedies are normally ongoing remedies designed to modify or constrain the behaviour of the merged firms, by mandating the price, quality or output of the merged firm's goods or services, or otherwise modifying their dealings with other firms.

11. The ACCC has a strong preference for structural undertakings—that is, undertakings to divest part of the merged firm to address competition concerns. Structural undertakings provide an enduring remedy with relatively low monitoring and compliance costs.

12. On occasion, behavioural undertakings—that is, undertakings by the merged firm to do, or not do, certain acts (for example, meet specified service levels)—may be appropriate as an adjunct to a structural remedy. Behavioural remedies are rarely appropriate on their own to address competition concerns.

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Structural undertakings—divestitures

13. Divestiture is generally the most common form of structural remedy accepted by the ACCC. In essence, a divestiture seeks to remedy the competitive detriments of a merger by either:

    - creating a new source of competition through the disposal of shares, interests, a business or a set of assets to a new, competitive market participant, or
    - strengthening an existing source of competition through disposal to an existing market participant independent of the merging parties.

14. As a general rule, divestiture undertakings aim to ensure that the ultimate purchaser of the divestiture assets will be a viable, long-term, independent and effective competitor to the merged firm, in a way that addresses the ACCC's competition concerns with the merger.

15. Key elements of a divestiture are the scope of the divestiture package, the purchaser selection and the disposal process. While merger parties will generally seek to offer divestiture remedies that satisfy the ACCC's requirements so that the merger is not opposed, they may have a conflicting incentive to undermine the future competitive effect of any divested assets and businesses where those divested assets or business will compete against the merged firm post-merger. Each of the key aspects of the divestiture may be susceptible to a number of risks such as:

    - composition risks—the scope of the divestiture package may not be appropriately configured (or sufficiently wide, say, in product range) to attract a suitable purchaser or allow a suitable purchaser to operate effectively
    - purchaser risks—a suitable purchaser may not be available or the merging firms may attempt to dispose of assets to a weak or otherwise inappropriate purchaser
    - asset risks—the competitive capability of a divestiture package may deteriorate significantly before completion of a divestment, for example through loss of customers or key members of staff, or there may be some impediment to sale such as third party approvals, or minority shareholder actions.

16. The ACCC closely examines the nature and extent of the undertakings offered against such risks in any individual case.

17. Generally, for a structural undertaking to be acceptable to the ACCC, all of the following requirements should be satisfied:

    - the divestiture remedy should be proportionate to the competition concerns or detriments and be effective in restoring or maintaining competition
    - the assets must be sold to a viable, effective and long-term competitor. That is, the part of the merged firm to be divested (for example, a subsidiary or a suite of assets) must facilitate the maintenance or creation of an independent and effective long-term competitor in the market. There should be no need for continuing supply or other arrangements between the merged firm and the purchaser of the divested business
    - there must be procedures for the purchaser to be approved by the ACCC. Generally, purchasers should be independent of the merged firm and possess the necessary expertise, experience and resources to be an effective long-term competitor in the market. The purchaser's acquisition of the divestiture business must not itself raise competition concerns in any market
    - the value and integrity of the divestiture package must be preserved and independently maintained and operated as a going concern, pending divestiture. Wherever practicable,

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divestiture should occur on or before the completion date of the merger, particularly in cases where there are risks in identifying a (suitable) purchaser or asset-deterioration risks. There will be some specific circumstances where, if the remedy cannot be implemented on or before completion of the main transaction to address the identified competition concerns, no remedy will be acceptable to the ACCC

- appropriate provisions will apply, should firms fail in their core obligations. For example, an undertaking should provide for the merged firm to appoint an ACCC-approved sales agent to divest the business to an ACCC-approved purchaser if the firm fails to sell the divestiture business itself within the requisite period
- appropriate provisions will apply to enable the ACCC to monitor and investigate compliance with the undertakings and enforce the provisions if necessary. For example, an undertaking may require the appointment of an ACCC-approved independent auditor or other independent expert to monitor certain aspects of the undertakings, contain provisions that require periodic reporting by the undertaking parties or an auditor, and contain provisions to enable the ACCC to obtain information about compliance with the undertakings
- remedies will also be required to be implemented in a timely manner.

18. In each case the specific measures and provisions needed to achieve these requirements (and further requirements if appropriate) may differ, in accordance with the circumstances of each case. Examples of specific provisions found to be acceptable to the ACCC in previous matters and that may assist merger party/parties in developing undertakings proposals can be found on the ACCC website (www.accc.gov.au).

Behavioural undertakings

19. The nature of effective behavioural undertakings will depend on the particular competition concerns they seek to address and the likely future state of competition in the relevant markets. It is therefore difficult to provide clear guidance as to whether behavioural undertakings will be appropriate to remedy the competition issues in any given matter.

20. Generally, behavioural undertakings are only likely to address the ACCC's competition concerns if they foster the development or maintenance of enduring and effective competitive constraints within a short and pre-specified period of time. It is particularly rare for the ACCC to accept behavioural remedies that apply on a permanent basis due to the inherent risk to competition combined with the monitoring and enforcement burden such remedies create.

21. An effective behavioural undertaking must contain an effective mechanism for the on-going monitoring and compliance and investigation of suspected breaches of the undertaking by the merged firm. Commonly, behavioural undertakings provide for the appointment of an ACCC-approved auditor to monitor compliance and report back to the ACCC.

Process

22. The *Merger review process guidelines* and *Formal merger review process guidelines* explain the ACCC's processes when considering a proposed undertaking.

23. To the greatest extent possible, subject to the legitimate confidentiality concerns of the parties, the ACCC will seek to ensure that the reasons for accepting an undertaking are publicly available and that undertakings accepted for one merger are broadly consistent with the undertakings accepted in other merger cases.

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24. A party to an undertaking may withdraw or vary their undertaking at any time but only with the consent of the ACCC.

Enforcement

25. The ACCC considers that s. 87B undertakings play a critical role in administering and enforcing s. 50 of the Act. Accordingly, the ACCC carefully monitors compliance with all undertakings it accepts and will investigate if it identifies any potential non-compliance. The ACCC will not hesitate to take enforcement action if it considers that an undertaking has been breached, and that court action is the appropriate response in the circumstances.

26. In the event of non-compliance with an undertaking the ACCC may make an application to the Federal Court for an order under s. 87B(4), and the court may, if it is satisfied that the party to the undertaking has contravened a term of the undertaking, make all or any of the following orders:

- an order directing the person to comply with that term of the undertaking
- an order directing the person to pay to the Commonwealth an amount up to the amount of any financial benefit that the person has obtained directly or indirectly and that is reasonably attributable to the breach
- any order that the court considers appropriate directing the person to compensate any other person who has suffered loss or damage as a result of the breach
- any other order that the court considers appropriate.

27. Further, the ACCC will generally not cede the legal right to take action in an undertaking. An undertaking accepted by the ACCC does not preclude the ACCC from taking legal action under s. 50, particularly if the undertaking is not properly implemented or the decision to accept the undertaking was based on inaccurate information.

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Glossary and shortened forms

Note: in these guidelines, the term 'product' encompasses both goods and services.

ACCC	Australian Competition and Consumer Commission
Act (the)	*Trade Practices Act 1974* (Cwlth)
behavioural undertakings	An undertaking that prescribes conduct to be carried out, directed or avoided by the merged firm on an ongoing basis to minimise its ability to exercise anti-competitive market power.
complementary products	Products are complementary in either demand or supply where a change in the demand for one generates demand for the other. If the price of one product rises, demand for both products may fall. Similarly, if the price of one product falls, demand for both products may increase.
conglomerate mergers	Mergers involving firms that interact or potentially interact across several separate markets and supply products that are in some way related to each other—for example, products that are complementary in either demand or supply.
court (the)	Federal Court of Australia
CRx	The x firm concentration ratio. This ratio is the fraction of market shares possessed by the 'x' largest firms in a given market. The higher the concentration ratio, the greater the level of concentration in that market.
differentiation	Differences in the features of a range of products that all serve the same function.
economies of scale	The economic principle whereby a firm's long-run average total cost of production is decreased as the quantity of that firm's output is increased.
economies of scope	The economic principle whereby a firm's long-run average total cost of production is decreased as the quantity of different goods produced by that firm is increased.
failing firm	A firm that is likely to exit a particular market in the foreseeable future (generally within one to two years) with its productive capacity leaving the market—that is, not simply a change in ownership.
foreclosure	Refers to when a firm prevents or impedes a rival firm from competing.
guidelines (the)	*Merger guidelines*, Australian Competition and Consumer Commission (2008)
HHI	Herfindahl-Hirschman Index—a metric used to estimate the post-merger level of concentration of markets, as well as changes in the concentration of markets as a result of a merger. The HHI is calculated by adding the sum of the squares of the market share of each firm in a particular market.
HMT	Hypothetical monopolist test—the HMT identifies the smallest area in product and geographic space within which a hypothetical current and future profit-maximising monopolist could effectively exercise market power.

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horizontal mergers	The merging of firms operating in the same market or markets.
ICN	International Competition Network
market participant	A firm that operates in a particular market or markets, such as a supplier or customer.
maverick firm	A firm with a relatively small market share in a particular industry that is considered a vigorous and effective competitor and which generally drive significant aspects of competition, such as pricing, innovation and/or product development.
merger factors	The non-exhaustive list of factors set out in s. 50(3) of the Act that must be taken into account when assessing whether a merger will contravene the Act, as well as any other factors relevant to the effect of a merger on competition.
minimum efficient scale	The minimum size (typically in terms of output, capacity or customer base) that a firm requires to compete effectively with incumbent suppliers in a market.
niche segment	Refers to a portion of a differentiated market serviced by small, specialised suppliers and often involving products that are in some way distinct from the products of larger suppliers.
notification threshold	The threshold established by the ACCC to identify mergers that should be notified to it (see chapter 2 of these guidelines).
public competition assessment	This outlines the basis for the ACCC reaching its final conclusion on a merger when: the merger is rejected; the merger is subject to enforceable undertakings; the merger parties seek such disclosure; or the merger is approved but raises important issues that the ACCC considers should be made public (published at www.accc.gov.au/mergers/register).
section 87B undertaking	A court enforceable undertaking under s. 87B of the Act that may be accepted by the ACCC to assuage any competition concerns identified.
SSNIP	A small but significant and non-transitory increase in price
statement of issues	This provides the ACCC's preliminary views on a merger which raises competition concerns requiring further investigation.
structural undertakings	An undertakings that provides for one-off actions that alter the entry conditions, or the vertical or the horizontal relationships in a particular industry. Structural undertakings will typically involve the divestment of part of a merged firm.
sunk costs	Costs that have already been committed by a firm to its business and cannot be recovered on exiting the market.
supply elasticity	This is a measure of how much the quantity of product supplied by a firm responds to specific changes in its particular market (for example, a change in the price of the product, a fall in input prices, or an improvement in production technology).

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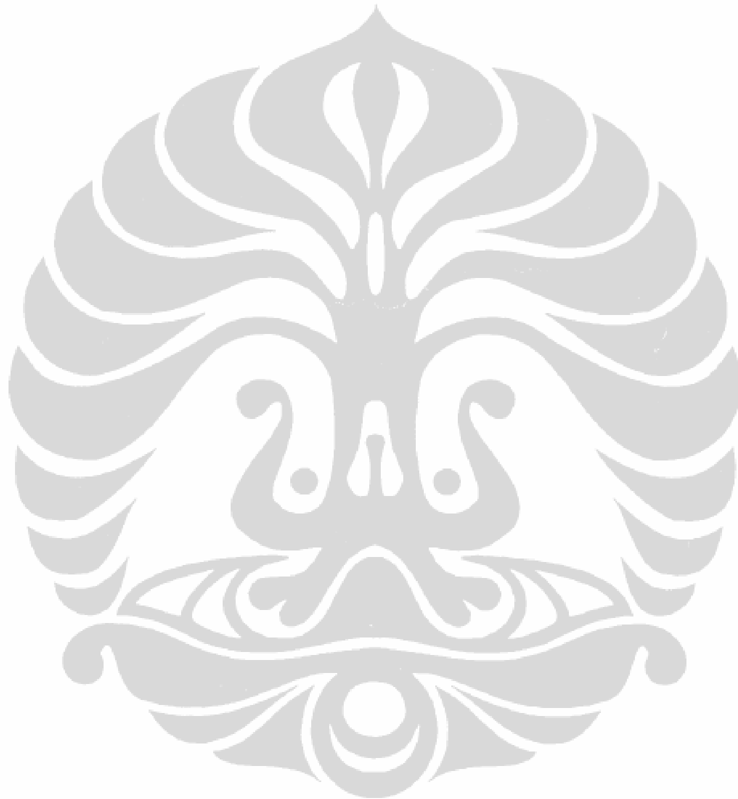
switching cost	Refers to the cost for customers to switch suppliers (for example, including search costs, transaction costs and market specific behaviour).
Tribunal (the)	Australian Competition Tribunal
undertaking	see section 87B undertaking
vertical mergers	A merger involving firms operating or potentially operating at different functional levels of the same vertical supply chain.



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Guidelines on the Definition of Relevant Market

(1) Market definition is an instrument used in establishing the limits of competition between undertakings. This instrument allows the Competition Board (the Board) to set the framework for the application of the competition policy. The main goal of competition policy is to determine the competitive conditions faced by the undertakings under examination*. The goal in defining a market in both product and geographic dimensions is to ascertain which competitors have the power to restrict the behavior of the undertakings under examination, and to prevent these from behaving independently of an efficient competitive pressure. In relation to market power, market definition facilitates the market share calculations, which are particularly important for the implementation of Articles 6 and 7 of the Act no 4054 on the Protection of Competition, dated 07.12.1994 (the Act).

(2) In general, undertakings use the concept of market to mean the area in which they sell their products or, in a larger sense, the industry or sector in which they operate. However, in competition law practice, the concept of relevant market is somewhat different from market concepts used in other areas. The goal of publishing this guideline is to state, as clearly as possible, the method used for defining a market and the criteria followed for taking a decision by the Board, in order to minimize the uncertainties undertakings may face.

1. RELEVANT MARKET

1.1. Relevant Product and Relevant Geographical Markets

(3) Article 4 of the Communiqué No. 1997/1 on the Mergers and Acquisitions Which Require the Authorization of the Competition Board, published in the Official Gazette No. 23078, dated 12.08.1997, includes the definitions of relevant product and

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* For he purposes of this guideline, undertakings under examination are the parties to the concentration in a concentration case, relevant undertaking(s) in an evaluation conducted under Article 6 and the parties of the agreement, concerted practice or decision in an evaluation conducted under Article 4.

relevant geographical markets and, similarly, this definition is also included in Article 3 of the Notification Form of Guidelines on the Voluntary Notification of Agreements, Concerted Practices, and Decisions of Associations of Undertakings[**].

In Communiqué No 1997/1, it is stated that the following factors shall be taken into consideration when determining the relevant product market:

"In determining the relevant product market, the market comprising the goods or services which are the subject of a merger or an acquisition, and the goods or services which are deemed identical in the eye of consumers in terms of their prices, intended use and characteristics is taken into account; other factors that may affect the market determined shall also be assessed."

The definition of relevant geographical market in Communiqué No. 1997 is as follows:

"The geographical markets are areas in which undertakings operate in the supply and demand of their goods and services, in which the conditions of competition are sufficiently homogenous, and which can easily be distinguished from neighboring areas, as the conditions of competition are appreciably different from these areas."

(4) The Board takes the criteria in this guideline into consideration both in the interpretation of the aforementioned definitions and in the application of the Act and the communiqués related to the relevant market concept.

1.2. The Concept of Relevant Market and the Goals of Competition Policy

(5) The concept of relevant market is closely related to the goals that the Board wishes to achieve through competition policy. For instance, the aim of the Board in concentration control policy is to prevent a significant reduction in competition in the

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[**] Similarly, definitions for product markets are given in Article 3 of the Block Exemption Communiqué mo 2002/2 on Vertical Restraints as well as in Article 3 of the Block Exemption Communiqué no 2005/4 on Vertical Agreements and Concerted Practices in Motor Vehicles Sector.

whole or part of the country by the creation or strengthening of a dominant position. According to the competition policy of the Board, a dominant position is when one or more undertakings have the power to determine economic parameters by acting independently of their competitors and customers[***]. Such a situation generally arises when the undertaking/undertakings is/are responsible for most of the supply in the market and when some other factors (barriers to entry, the capacity of consumers to respond, etc.) also point in the same direction.

(6) The Board follows the same approach when applying Article 6 of the Act to undertakings which hold dominant position individually or jointly as well. Under Article 6, in order to establish the existence of a dominant position, definition of relevant market is required. Market definition may also be used for the application of Articles 4 and 5 of the Act.

(7) A market definition for a concentration analysis study, which concerns the future, may be different than one created for an analysis concerning past behavior such as dominant position or competition limiting practices. Additionally, in time, different market definitions may also arise owing to consumer preferences, sales regions and product prices.

1.3. Basic Principles of Market Definition

1.3.1. Demand Substitution

(8) The evaluation of demand substitution requires determining other products which consumers deem substitutable for the relevant product[1]. A way to determine this is to assume a small, non-transitory change in prices and assess the potential responses of the consumers to this change. That is to say, market definition study takes the demand substitution arising from small, non-transitory changes in relative prices into consideration.

[***] Definition of Article 3 of the Act.

(9) Market definition shall start from the products and sales regions of the relevant undertakings. Other certain products and regions shall be added to the market definition based on their ability to affect and limit the short-term pricing decisions of these undertakings.

(10) In the products and regions under examination, it is important to see whether the customers switch to easily accessible substitute products or to suppliers in other places when faced with a small but evident and non-transitory hypothetical price increase. If the reduction in the sales of the product caused by the price increase is on a scale to prevent profits, other substitute products and regions are included in the market definition. This operation continues until a combination of products and regions is reached which enables profitable small and non-transitory increases in relative prices. A similar analysis may also be conducted in cases of concentration of purchasing power. In this case the analysis starts at the supplier and the price test is employed in determining the existing alternatives for the products of the supplier. When applying these principles, some special circumstances emphasized in paragraphs 44 and 46 must be taken into consideration.

(11) A merger between undertakings producing beverages maybe given as an example for demand substitution analysis. The critical point in this merger transaction is whether or not beverages of different flavors belong to the same market. It is important to see if the customers of flavor A will switch to different flavors when faced with a small and non-transitory increase in the price of flavor A. If a sufficient number of customers switch to flavor B and if, consequently, the reduction in the sales of flavor A makes the increase in its price non-profitable, it is concluded that the market includes the flavors A and B. This process shall continue including other existing flavors in the market into the analysis, until a product group is found where hypothetical increases in price do not create sufficient demand substitution.

(12) In markets where concentration is not high, in general the price to consider shall be the existing market price. However this situation may not be valid if the existing market price was determined in a situation where there was not sufficient competition. In particular, in abuse of dominant position investigations, existing

market price is generally significantly higher than the competitive price, due to the existence of market power.

1.3.2. Supply Substitution

(13) Supply substitution may also be taken into consideration where it has equivalent effect to demand substitution[2]. For this, suppliers must be able to switch their production to other products when faced with small and non-transitory increases in relative prices and they must be able to market these products without having to tolerate significant additional costs and risks in the short term. When these conditions are met, the additional production introduced to the market shall create competitive pressure on the undertakings under examination. Such an affect is equivalent to demand substitution in terms of efficiency and fast results.

(14) Supply substitution in paper production may be given as an example to this. Paper is generally introduced to the market in a range that includes products of various quality, changing from standard writing papers to high-quality papers used in the printing of art books. From the perspective of demand, it can be seen that papers of different quality cannot be used in the printing of the same publications. For instance, low-quality paper cannot be used when printing an art book or a high-quality book. Nonetheless, since paper mills are ready to manufacture papers of all qualities, they can switch from manufacturing paper of one quality to another with negligibly low costs and in a short time. In cases where there are no special problems related to distribution and especially where delivery period for orders are long enough to allow the necessary changes in the mill of the paper manufacturer, paper manufacturers can compete with each other to win the orders for different qualities of paper. In such cases the Board shall not define separate markets for each quality of paper and their areas of use. All papers shall be included in the relevant market and the total market value and volume shall be calculated based on the total sales thereof.

(15) In case the suppliers have to make significant changes to their material and non-material properties, make additional investments, take strategic decisions and spend significant time for all these operations in order to switch their production to different

products, supply substitution shall not be taken into consideration during market definition stage. Branded beverages may be given as an example to this. Even though basically bottling facilities have the ability to bottle all kinds of beverages, various costs and preparation periods (for advertisement, products tests and distribution) are involved until the products are ready for sale[3].

1.3.3. Potential competition

(16) Since it is not equally efficient as demand substitution in terms of fast results, potential competition is not generally taken into consideration for market definition.

2. CRITERIA TO CONSIDER IN THE DEFINITION OF RELEVANT MARKET

2.1. Definition of Relevant Market

2.1.1. Relevant Product Market

(17) When defining the product market, first of all, a preliminary opinion is prepared based on the existing information or the information provided by the undertakings parties to the case. It is important in this preliminary opinion to see whether or not alternative products are substitutes for each other.

(18) There are various criteria that determine substitution. These criteria may vary depending on the characteristics of the industry, goods or services under examination. A criterion used in an examination may be completely irrelevant for another investigation. When determining substitution, the Board avoids adopting a strict hierarchy concerning the various information sources or analysis types.

2.1.2. Relevant Geographical Market

(19) When defining the geographical market, first of all, a preliminary opinion is prepared based on the indications concerning the distribution of the market shares of the parties and competitors, as well as on the price differentiations. Afterwards, it is examined to see whether undertakings in different regions really serve as an

alternative source of supply for the customers. In this examination, demand structure is taken into consideration. Whether or not undertakings under examination can switch the orders of their customers to undertakings at other regions in a short period of time and at negligible costs shall constitute the basic point.

(20) However, in case the transaction under examination does not pose concerns for competition within the framework of potential alternative market definitions in terms of both product and geography, or in case there are competition distorting effects for all alternative definitions, a market definition may not be prepared[4].

2.2. Information Gathering Process

(21) Where a definitive market definition must be made, chief customers and undertakings in the industry may be contacted, in order to acquire the necessary information for the relevant market definition. Sometimes it may be necessary to define separate relevant product markets concerning different levels of the production or distribution of the goods/services under examination. In such cases, in order to define the aforementioned markets, professional organizations or undertakings in the downstream/upstream markets may be contacted.

(22) When deemed necessary, letters requesting information may be sent to the abovementioned players of the market. In these letters, information required for determining the borders of the relevant market is requested. Additionally, professional staff conducts interviews with the officials of the undertaking under examination and get more information on the subject of market definition. Professional staff may also visit and conduct examinations in the facilities of the parties, their customers and/or competitors in order to better understand how the products are manufactured and sold.

2.2.1. Factors Which May Be Used in the Definition of Relevant Product Market

(23) The characteristics and intended use of the relevant product is the first step in determining substitute products. However, on their own, the possibility to use one product instead of another one and existence of similar characteristics between

products are not decisive factors when the definition of the relevant product market is concerned[5]. That is because the response of the customers to relative prices may be determined by the effect of other factors. For instance concerning automobile parts, competitive conditions in the original parts market may be very different from those for spare parts market. In this case, it may be necessary to define two different markets for automobile parts, such as original spare parts market and spare parts market. And on the other hand, the differences between product characteristics are not sufficient on their own to decide that there is no demand substitution between the products.

(24) The criteria the Board shall take into consideration when assessing whether or not two products have demand-side substitutability may be classified as follows:

(25) *Findings indicating the products substituted each other in the recent past:* In some examinations, it may be possible to analyze information concerning cases in the recent past or changes in the market which may constitute examples that two products were substitutes for each other. Naturally, such information is taken as a basis for market definition. Where there was a change in relative prices in the recent past (other factors being equal) responses in demand shall be decisive in determining the substitution level. If it is possible to conduct an analysis concerning which products lost sales where new products were introduced into the market in the past, valuable information for relevant product market definition may be gathered.

(26) *Quantitative tests specifically developed for determining the market:* These tests include various econometric and statistical approaches such as demand elasticity and cross-price elasticity calculations for a certain product, analysis for similarity of price changes in time, causality between price series and similarity of price levels[6]. The Board takes quantitative analysis with sound basis into consideration for market definition.

(27) *Opinions of the customers and competitors:* Main customers and competitors of the undertakings under examination may be contacted, in order to gather opinions concerning the borders of the product market and required information. Where they

are supported by sound findings, opinions of the customers and competitors on potential product and geographical market definitions are taken into consideration.

(28) *Consumer choices:* Marketing analysis conducted and used by the undertakings in their own decision-making processes on marketing may provide useful information to the Board in relation to market definition[7]. However, consumer surveys conducted by the relevant undertakings or their competitors specifically for an examination/investigation under the Act shall be examined in a very thorough manner[8]. This is because unlike previously conducted analysis, these surveys are not prepared to serve as a basis to the commercial decisions of the undertakings.

(29) *Costs and barriers related to switching the demand to potential substitute products:* Some barriers and costs related to the sector may cause the Board to decide that two products which, at first glance, appear to be substitutes in fact belong to separate markets. It is not possible to make a full list of the factors which prevent substitution and the costs for switching from one product to the other. Limitations arising from various legal regulations and state interventions, limitations in the downstream markets, significant capital investments, areas where the customers live, investments to the production process, investments to training and human resources, reprocessing costs may be given as examples to this subject.

(30) *Different customer categories and price discrimination:* Where there are distinctly different customer groups, the borders of the product market may be reduced. A different group of customers for the relevant product may form a smaller and separate market in case there is price discrimination to its disadvantage. This situation generally occurs when two conditions are met: (a) if it is not possible to determine which group a customer belongs to during the sale of the relevant product, and (b) if trade between the customers or arbitrage by third parties is not economical or possible.

2.2.2. Factors Which May Be Used in the Definition of Relevant Geographical Market

(31) The criteria the Board shall take into consideration when taking a decision concerning geographical markets may be classified as follows:

(32) *Findings that indicate orders were switched to different regions in the past:* Price differences between different regions and customer responses provide important information concerning the definition of geographical market.

(33) *Quantitative tests specifically developed for determining the market:* In general, quantitative tests used in product market definition may also be used in geographical market definition. As in product markets, the Board shall take analysis with sound basis into consideration.

(34) *Basic characteristics of demand:* The structure of demand for the relevant product can determine the scope of the geographical market on its own. Factors such as regional preferences, loyalty to local brands and the necessity for an active presence in the regional market have a strong potential to limit the geographical scope of competition.

(35) *Opinions of customers and competitors:* Main customers and competitors of the parties under examination may be contacted in order to determine the scope of the market[9].

(36) *Existing geographical trends of purchases:* Examination of the geographical trends of customers' purchases provide useful information concerning the potential scope of the geographical market. In general, where customers purchase from undertakings at different areas of Turkey under the same terms, or where they can meet their needs via tenders in which undertakings operating at any area of Turkey may bid, the geographical market is the Republic of Turkey.

(37) *Trade flow / Goods Delivery trends:* In case sufficient statistics on the relevant products are available, trade flow information may be used[10]. While trade flows and, more importantly, the reasons behind these flows provide opinions and information very valuable for determining the scope of geographical market, they are not sufficient on their own to arrive at a decisive conclusion.

(38) *Barriers related to shifting orders to undertakings at other regions and switching costs:* High shipping costs or various limitations caused by the nature of the product may prevent customers' switching their purchases to other regions[11]. The effects of shipping costs are generally apparent in large-sized, low-value products. However, in this situation, it should be noted that shipping disadvantages may be offset by relative advantages in other costs (such as costs related to the labor force or raw materials). Conditions of access to a distribution system in a region and limitations tied to legal regulations in some sectors may also isolate that region from the competitive pressure of the undertakings which are outside of that region.

(39) Based on the available information, the Board shall define a market the size of which may vary from local to international. Examples for local and international market definitions are available in the past decisions of the Board[12].

(40) In the above paragraphs information is given related to various criteria which may be significant in market definition. This does not mean that each of these criteria should be taken into consideration for every examination. As is apparent from the previous Board decisions, in practice only some of these criteria have been sufficient to reach a conclusion most of the time.

3. CALCULATION OF MARKET SHARES

(41) Definition of relevant product market and relevant geographic market enables the determination of suppliers and buyers/consumers active in that market. From this point, based on the suppliers' sales of the relevant product in the relevant region, total market size and the market share of each supplier may be calculated. Total market size and market shares can mostly be calculated from the data of research companies or from the studies of the professional associations. When this is not possible or when available estimations are deemed unreliable, each supplier may be requested to provide its own sales numbers in order to calculate the total market size and market shares.

(42) Even though the reference point in determining market shares are generally sales numbers, depending on the characteristics of the relevant product or industry,

other indicators such as capacity[13], number of actors in the tender market, fleet size in aviation or the amount of reserves controlled in sectors like mining[14] can provide useful information.

(43) As a rule, sales numbers both in volume and in value provide useful information. In case of differentiated products, in general, it may be accepted that sales numbers in value and the related market shares reflect the status of the suppliers relative to each other as well as their market power.

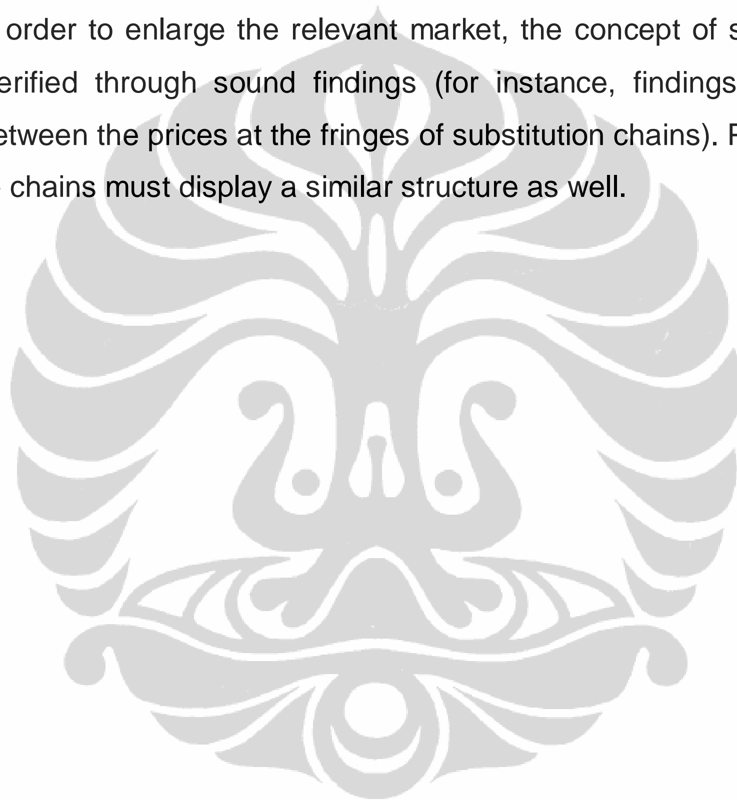
4. OTHER POINTS TO TAKE INTO CONSIDERATION

(44) Some situations require additional care in the application of the foregoing principles. In particular, when it is necessary to examine the behaviors of undertakings under Article 6, this is a consideration in the assessment of primary and secondary markets. In such cases, the method used is that of assessing the responses of the consumers to the changes in relative prices. However, this time the limitations on product substitution caused by the conditions in connected markets are also taken into consideration. Where compatibility with the primary product is important, this may cause a narrow market definition for secondary products such as spare parts[15]. When combined with the problems faced in finding compatible secondary products, the durability and high prices of the primary products may make relative price increases in secondary products profitable. If there is a possibility of substitution between secondary products, or if the characteristics of the primary products make it possible for the consumers to react promptly and directly to relative increases in the prices of the secondary products, a larger market definition for secondary products may emerge.

(45) In certain cases, the existence of substitution chains may cause a relevant market definition in which the products and regions at the fringes of the market can not be substitutes for each other. An example to this can be seen in the geographical market of a product with significant shipping costs. In such cases, sales from a factory are limited with a region around the factory due to the effects of transportation costs. Basically, geographical market is also expected to be comprised of the same region. However, in case there is substantial overlap between these regions due to

the positions of the factories which manufacture the same product, it is possible to limit the pricing of the relevant products through a chain substitution effect and to arrive at a larger geographical market as a result. The same logic may also be valid where product B is a demand-side substitute for products A and C. Even though A and C are not substitutes, the limitations on their pricing caused by the fact that they both can be substituted by B may lead to their inclusion in the same relevant product market.

(46) In practice, in order to enlarge the relevant market, the concept of substitution chains must be verified through sound findings (for instance, findings indicating interdependency between the prices at the fringes of substitution chains). Price levels at the fringes of the chains must display a similar structure as well.



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Market Investigation References: Competition Commission Guidelines

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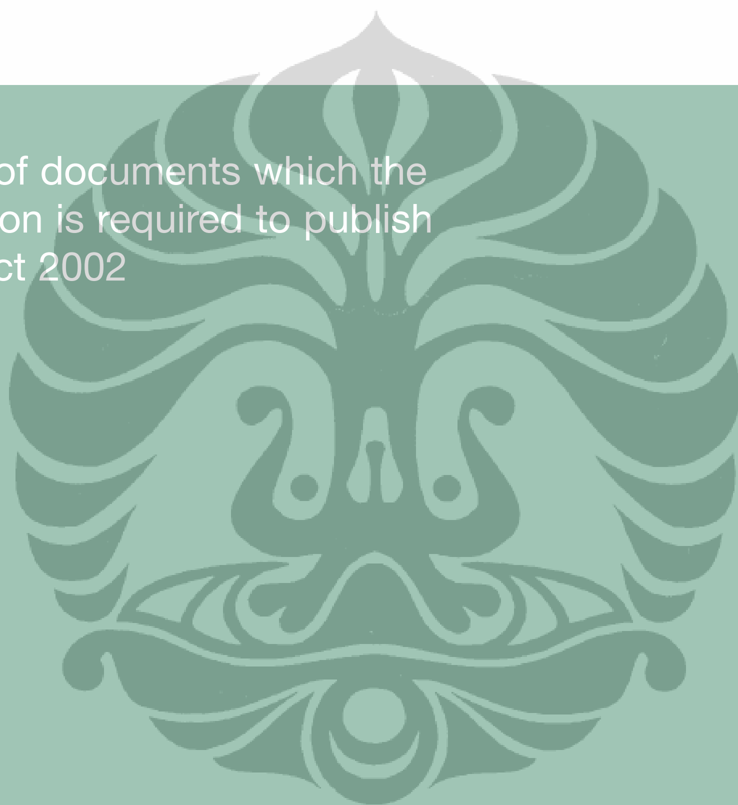

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Market Investigation References: Competition Commission Guidelines

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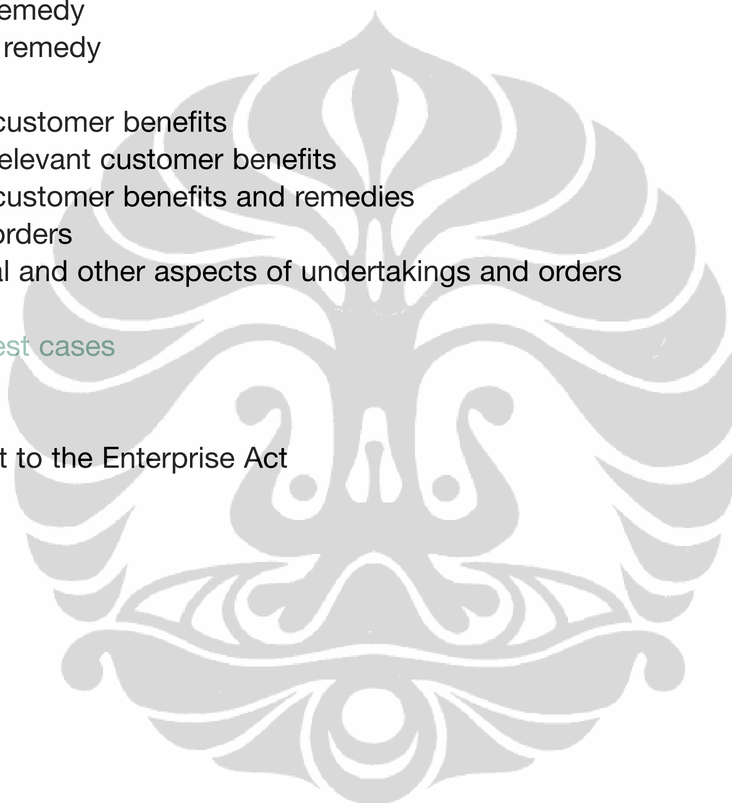

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Part 1: Introduction

Purpose of guidance

1.1 This guidance forms part of the advice and information published by the Competition Commission ("the Commission") under section 171(3) of the Enterprise Act 2002 ("the Act").[1] It explains the Commission's approach to the questions to be answered in respect of market investigation references made to it by the Office of Fair Trading (OFT) or by certain sectoral regulators with concurrent[2] powers under section 131 and by Ministers under section 132.

1.2 Information on procedural aspects of the Commission's investigation can be found in the Commission's *Rules of Procedure* ("the rules")[3] and *General Advice and Information*. Information about these and other publications of the Commission and the Office of Fair Trading (OFT) relevant to market investigation references can be found in the Annex to this document. A separate document *Merger References: Competition Commission Guidelines* (the merger guidelines) covers similar ground in respect of merger investigations.

1.3 This guidance reflects the views of the Commission at the time of publication. Markets, economic theory, legal thinking and best practice evolve. This guidance may be revised from time to time to reflect such change or in the light of the Commission's experience in applying the new market investigation regime and new guidance may be published. The latest version is always that appearing on the Commission's website.

1.4 In addressing the questions the Commission[4] must consider in respect of references made under sections 131 and 132, a group will have regard to this guidance and will apply such of the methodology and analysis summarised in it as it considers appropriate. However, the Commission will consider each reference with due regard to the particular circumstances of each case including the information that is available and the time constraints applicable to the case.[5] Accordingly, whilst aiming to use a systematic approach to investigations, the Commission will apply the approach described in this guidance flexibly and may, if it considers it appropriate to do so, depart from that approach.

The competition questions

1.5 On receipt of a market investigation reference, the Commission is required to decide:

whether any feature, or combination of features, of each relevant market prevents, restricts or distorts competition in connection with the supply or acquisition of goods or services in the United Kingdom or a part of the United Kingdom.[6]

If any feature, or combination of features, of a relevant market prevents, restricts or distorts competition in connection with the supply or acquisition of any goods or services in the UK or a part of the UK, under the Act this constitutes an 'adverse effect on competition'.[7] In this guidance we therefore refer to this question as the AEC test.

1.6 The phrase 'prevents, restricts or distorts' is familiar from the complex monopoly provisions of the Fair Trading Act 1973. (Similar phrases are also used in Chapter I of the Competition Act 1998 and Article 81 of the EC Treaty).

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[1] Except when otherwise indicated, all references to sections and to Schedules are references to sections and Schedules in or to the Act.
[2] Director General of Telecommunications, the Gas and Electricity Markets Authority, the Director General of Water Services, the Director General of Electricity Supply for Northern Ireland, the Director General of Gas for Northern Ireland, the Rail Regulator and the Civil Aviation Authority.
[3] Reference in the guidance to the rules are references to the proposed rules published on 1 March 2003.
[4] In respect of each reference a group is appointed to carry out the Commission's functions. For further information about the appointment of groups and the procedures that apply see *General Advice and Information* and the rules.

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The Commission will interpret this phrase broadly using its ordinary and natural meaning so as to include any adverse effect on actual or potential competition. In particular, the Commission will interpret this phrase to include one circumstance in which several features create a situation in which the suppliers do not compete to the extent they would in a fully competitive market.

1.7 Section 131(2) of the Act states that, for the purpose of a market investigation reference, a feature of a market in the United Kingdom shall be construed as:

(a) *the structure of the market concerned or any aspect of that structure;*

(b) *any conduct (whether or not in the market concerned) of one or more than one person who, supplies or acquires goods or services in the market concerned; or*

(c) *any conduct relating to the market concerned of customers of any person who supplies or acquires goods or services.*

Conduct includes any failure to act, whether intentional or not and any other unintentional conduct.

1.8 Where the Commission decides that there is an adverse effect on competition, it is required to decide the following additional questions:[8]

(a) *whether action should be taken by [the Commission]… for the purpose of remedying, mitigating or preventing the adverse effect on competition concerned or any detrimental effect on customers so far as it has resulted from, or may be expected to result from, the adverse effect on competition;*

(b) *whether it should recommend the taking of action by others for the purpose of remedying, mitigating or preventing the adverse effect on competition concerned or any detrimental effect on customers so far as it has resulted from, or may be expected to result from, the adverse effect on competition; and*

(c) *in either case, if action should be taken, what action should be taken and what is to be remedied, mitigated or prevented.*

1.9 A detrimental effect on customers is defined as one taking the form of:[9]

(a) *higher prices, lower quality or less choice of goods or services in any market in the UK (whether or not the market to which the feature or features concerned relate); or*

(b) *less innovation in relation to such goods or services.*

Overall framework

1.10 Market investigation references to the Commission will be made where the OFT (or, in some circumstances, a Minister or sector regulator)[10] has reasonable grounds for believing that competition is not working effectively (see OFT 501 *Market Investigation References*). The reference will describe the goods or services (referred in this guidance as products) and the OFT (or Minister, if appropriate) will indicate the feature or features that relate to the product that it (or he) believes have adverse effects on competition. The reference may require

[5] For further information about the statutory period and the circumstances in which the inquiry may be extended see *General Advice and Information*.
[6] Section 134(1).
[7] Section 134(2).
[8] Section 134 (4).
[9] Section 134(5). The reference to customers includes future customers.
[10] References in this Part to the OFT include references to the sectoral regulations having concurrent powers (see Footnote 2).

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the Commission to confine its investigations to the effects of features on markets in the United Kingdom in connection with a specified description of supply or acquisition.[11] The OFT's views (or those of the Minister, if appropriate) will provide the natural starting point for the Commission's own investigation. But the Commission must reach its own conclusions on the effects of any features of the market subject to investigation. The Commission may, however, when deciding whether there is an adverse effect on competition, base its decisions on different features from those identified by the OFT (or Minister, as appropriate). It is entirely for the Commission to decide how any adverse effects on competition or detrimental effects on customers should be remedied.

1.11 The Government's intention is that market investigation references will focus upon the functioning of a market as a whole rather than the conduct of a single firm in a market. If the OFT has concerns about the conduct of a single firm, its first response is to consider whether the prohibition of the abuse of dominance in the Competition Act 1998 (the Competition Act) has been infringed. Similarly, if it suspects that firms have engaged in anti-competitive agreements it will first consider whether these infringe the prohibition of such agreements. However the Competition Act does not necessarily cover all types of competition concern. If, for example, anti-competitive conduct of a single firm is associated with structural features of a market, such as regulations or Government policies, it may be more appropriate for the OFT to make a market investigation reference than to take action under the Competition Act. Similarly, competition concerns may arise in oligopolistic markets even though no anti-competitive agreements exist between firms (as explained in paragraphs 3.58 to 3.67), hence triggering a market reference. More generally, OFT guidance (OFT *Market Investigation References*) indicates that it will consider whether to make a reference if it has reasonable grounds to suspect that there are market features which may prevent, restrict or distort competition, but does not believe there is evidence to establish a breach of the Competition Act. It may also consider whether to make a reference when action under the Competition Act has been or is likely to be ineffective to deal with the adverse effect on competition identified.

1.12 The European Community has revised the main regulation implementing Articles 81 and 82 of the EC Treaty (Regulation 17/62/EEC) with effect from 1 May 2004.[12] From that date Member State national competition authorities and courts have the responsibility, shared with the European Commission, for the application of Articles 81 and 82. National competition authorities and national courts will be obliged to apply Articles 81 and 82 where they apply national competition law to agreements or practices which may affect trade between Member States.

1.13 In the context of a market investigation, the obligation to apply Articles 81 and 82 in parallel with national competition law will arise only at the stage where remedies are imposed by the Commission. The obligation does not affect the exercise by the Commission of its powers of investigation.

1.14 If during the course of its investigation the Commission uncovered a potential breach of Article 81, it would consider the application of the modernisation regulation and whether the agreement, decision or concerted practice should be remitted back to the OFT for further consideration of the application of

[11] Section 133.
[12] Council Regulation (EC) No 1/2003 of 16 December 2002, "the modernisation regulation".

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Article 81. The Commission might, for example, continue with its investigation but take the application of the modernisation regulation into account when determining whether to take remedial action (including whether it is prevented from taking action in respect of the agreement) and if so what action to take. If during the course of its investigation the Commission found evidence suggesting a breach of Article 82, it would normally continue with its investigation and, when appropriate, implement remedies under the Act. The OFT would then take such action into account when carrying out an Article 82 investigation.

Adverse effects on competition

1.15 Whilst market investigation references to the Commission will be made where the OFT (or, in some circumstances, a Minister or sector regulator) has reasonable grounds for believing that competition is not working effectively, it will be for the Commission to reach its own conclusions on whether there are any adverse effects on competition.

1.16 In doing so, the Commission sees competition as a process of rivalry between firms or other suppliers (hereinafter referred to as firms) seeking to win customers' business over time.[13] This rivalry may occur in a variety of ways. In some cases the emphasis will be on achieving the lowest level of costs and prices in order to undercut competitors. In other cases, firms may go well beyond this, using entrepreneurial and innovative skills to develop new products and services, exploit particular strengths, abilities or other advantages held by a firm and, by these means, meet consumer needs more effectively than competitors. Where these factors are important, competition will often be characterised by uncertainty, turbulence and change. Amongst other things, therefore, this process of rivalry may be illustrated by changes in market structure, the pattern of pricing over time or the extent of product innovation, for example. Whatever forms the process of rivalry takes, the Commission will consider its effects over time and how it may be expected to develop.

1.17 Rivalry has numerous beneficial effects: prices and costs are driven down, and innovation and productivity increase, so increasing the quality and, more generally, the diversity of choice available to customers. Further, markets that are competitive generate feedback from customers to firms who, in consequence, direct their resources to customers' priorities. In addition firms are encouraged to meet the existing and future needs of customers as effectively and efficiently as possible. It is where this process is hampered, or otherwise hindered, by features of the market that competition may be adversely affected. The degree of rivalry between firms or other producers for customer business and the threat of entry faced by incumbents are the main competitive constraints on firms, although other constraints such as buyer and/or supplier power may also, in some cases, be significant.

1.18 As part of a market investigation, the Commission must consider how the competitive process in the relevant market is affected by any features of the market as described in the Act. Structural features include not only market shares, concentration, buyer power and entry barriers, but also less obvious aspects of market structure such as information asymmetries and government regulations. Conduct features include the conduct of buyers and sellers, of the

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[13] Other producers from which firms face competition need not be simply other commercial firms but might include government for example.

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firms in the market and of customers. Each of these features may have effects on competition, in both its more static sense of price, cost and profit levels and its longer term dynamic sense of experimentation with new ideas, innovation, differentiation and development of products and markets through time. In its analysis, therefore, the Commission will consider the extent to which the process of rivalry in the market will ensure that all firms in the market are open to challenge, that no firm's position or market share is insulated from competitive pressure and that none can exert market power.[14]

1.19 In some market investigation references the Commission may find that for certain aspects of the market, or in some parts of the market, there is effective competition, but less than fully effective competition elsewhere in the market (possibly creating scope for cross-funding of some activities). In such instances the Commission will address the less competitive areas of the market, normally with the aim of securing effective competition in all areas of the market.

1.20 Inevitably a degree of judgement is involved in deciding whether there are adverse effects on competition. Where the line is to be drawn has to be judged in each individual case in the light of all the evidence that has been assembled in the course of the investigation.

The Commission's approach

1.21 The Commission's approach to market investigation references will normally be framed in terms of two related issues. The first concerns the identification of the relevant market (or markets) for the goods or services concerned (hereafter referred to as products). The relevant market may not coincide with the particular goods or services that are described in the reference. The reference will have outlined the market definition that OFT believes to be relevant to the investigation, but as OFT's Guidance indicates, the OFT does not have to reach a conclusive view on market boundaries.[15] The second concerns the Commission's assessment of competition in the market and whether any features of the market adversely affect competition.

1.22 In practice the analysis of market definition and the assessment of competition will overlap significantly, with many of the factors affecting one being relevant to the other. For instance, in contemplating the extent of supply-side substitution for the purposes of identifying the relevant market, it is likely that the potential for entry and expansion, a key issue in the assessment of competition, will also be considered. Therefore, market definition and competition assessment should not be viewed as two distinct chronological stages – rather they should be viewed as two overlapping analyses. Market definition can be thought of as a framework within which to analyse the effect of features of the market on competition.

1.23 Part 2 looks at market definition and Part 3 considers the assessment of competition within the relevant market. Therefore, these two Parts focus on the key issues that are considered in an analysis of whether any features of a market have an adverse effect on competition. Part 4 describes the factors the Commission takes into account when deciding on the remedy questions. Part 5 relates to public interest cases.

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[14] Market power may be described most simply as the ability to raise price consistently and profitably above competitive levels (or where a buyer has market power, the ability to obtain prices lower than their competitive levels).
[15] OFT guidance, *Market Investigation References*.

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Part 2: Market definition

Introduction

2.1 An important element in a market investigation is to define the market (or markets) relevant to an assessment of the effect of market features. There are normally two dimensions to the definition of a market: a product dimension and a geographical dimension. The products that should be included in the relevant market, and the geographic boundaries of that market, are determined by the extent to which customers can readily switch between substitute products, or suppliers can readily switch their facilities between the supply of alternative products. The key to market definition is substitutability.

2.2 As noted earlier, the Commission does not regard market definition as an end in itself, but rather as a framework within which to analyse the effects of market features. The definition of the relevant market is a useful tool for identifying the competitive constraints present in the market. There is inevitably an element of judgement involved in defining the market and the Commission will adopt the methodology most appropriate in the context of the investigation. The generally accepted conceptual approach to market definition, used in many jurisdictions, is the SSNIP test (also known as the hypothetical monopolist test). The Commission will adopt this approach wherever it is feasible to do so.

2.3 The next section looks at how the SSNIP test can be used when considering the product market. In doing so it considers both demand-side and supply-side substitution. It then explains how the SSNIP test might be used when defining the geographic market before considering some other aspects related to market definition, for example chains of substitution.

SSNIP test

(a) Product market

2.4 In using the concept of the SSNIP test for product market definition, the Commission will consider whether a hypothetical monopolist of a certain product or set of products, which might constitute a market, could profitably impose a small but significant non-transitory increase in price (SSNIP). The principle behind the test is that a market is defined as a product, or collection of products, the supply of which can, hypothetically, be monopolised profitably.

2.5 The application of the SSNIP test is an iterative process. It starts by considering each product (narrowly defined) in the market reference. The following question is then asked: if there were only one supplier of the product (a hypothetical monopolist), would it be able to sustain a SSNIP profitably? If the price rise is unprofitable, because consumers would switch their consumption to other products, then the closest substitutes are added to the product group and the procedure is repeated. Some analysis of the characteristics of the product including its intended use may, therefore, be necessary in order to establish possible substitutes that might be included

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in the group of products to be used in the SSNIP test. The relevant product market is normally defined as the smallest group of products for which a hypothetical monopolist could sustain a SSNIP profitably.

2.6 Occasionally the process of market definition may not give a clear-cut or unique answer. Whilst in most instances the Commission will want to be clear as to its preferred market definition, its duty is to decide whether any features of a market adversely effect competition. As a result, it will not devote disproportionate resources to determining exactly whether a particular competitive constraint results from within the market (and so should be included in the market definition) or from outside the market, provided that the alternative market definitions do not make a substantial difference to the analysis.

2.7 Commonly, the concept behind the SSNIP test has been to assume a price increase for the group of products in question in the range 5 –10 per cent, whilst all other prices remain unchanged. Whilst the absolute size of the price rise used will depend on the circumstances of the investigation, the Commission will normally hypothesise an increase of around 5 per cent, whilst assuming all other prices remain unchanged. This price rise is assumed to last for the foreseeable future and the Commission will typically consider the extent of response which is likely to occur within a year of the price rise (although the exact time period will depend on the nature of the market considered).

2.8 The Commission will normally use 5 per cent for the SSNIP test, rather than the more common 5 – 10 per cent, because in many instances an increase in the price of a product of around 5 per cent (with all other prices unchanged) might reasonably be judged to have a significant effect on customers' expenditure on that product and so provides an appropriate level at which to consider the test. In addition, a 5 per cent increase in price might also be expected to have an appreciable effect on a firm's profit margin, the main issue then being whether demand would be reduced to such an extent as to offset the effects of the higher margin. However, in some cases 5 per cent might be an inappropriate level at which to conduct the SSNIP test and in such cases the Commission will use a more suitable figure given the nature of the market in question.

2.9 One difficulty in considering the SSNIP test is that the existing price may be significantly above (or below) the price level that would result from a fully competitive market. This might be the case, for example, where a market is already to some extent monopolised, or where for some other reason prices are above competitive levels (for instance, see the section on coordinated effects, paragraph 3.58 to 3.67). In some cases, prices will have already been raised to the level at which a further price rise would lead a significant number of purchasers to stop buying, or switch to alternatives that would not otherwise have been regarded as reasonable substitutes. As a result, a further price rise might well be unprofitable. The application of the SSNIP test might, therefore, erroneously suggest that other products should be included in the resulting product market even though they would not have been seen as substitutes had the competitive price level been used as the starting point for the test.[16]

[16] This problem is generally known as the "cellophane fallacy" after the Du Pont case in the US (US v El Du Pont de Nemours & Co, [1956] 351 US 377).

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2.10 The problem for the Commission is that at the outset of a market investigation it is unlikely to be in a position to be able to judge decisively whether the existing price level is competitive or not, or indeed whether the prices of possible substitutes are at the competitive level or not. Therefore, in practice, the Commission will most likely use existing prices in its initial consideration of market definition. However, where the Commission's subsequent understanding of the market leads it to believe that prices are substantially above the competitive level, the Commission would normally wish to use prices indicative of the competitive level in its analysis of market definition.

2.11 Another difficulty is that it is generally not possible to apply the SSNIP test in any direct sense, that is to say actually observing a 5 per cent price increase across the products concerned and identifying the consequence for demand and for the profitability of the products concerned. Given this, it is usually necessary for the Commission to infer, from whatever information is available or can be collected, what the likely outcome of the SSNIP test would be. This can then be used to determine market definition.

2.12 The overall effect of the SSNIP on profit will depend on the net effect of three factors:

- the decline in the quantity sold as customers switch to other products;
- any change in the costs of production, as the quantity produced decreases; and
- the margin earned on each unit sold.

2.13 The first effect, substitution, is often a key focus of the Commission's analysis of market definition and is considered below. In order to measure the second and third of these effects the Commission would need information on actual costs and margins and how they change with the amount produced. This would provide direct information on whether any price increase would be profitable or not.

2.14 The effect of customers switching to substitute products following a SSNIP is called demand-side substitution and is considered in the following section. The effect of other suppliers commencing or increasing the supply of the products whose price rises following a SSNIP is called supply-side substitution. New suppliers commencing production (of the products whose price rises) might be considered, in some instances, as new entry and the distinction between supply-side substitution and new entry is considered after the section on demand-side substitution.

(i) Demand-side substitution

2.15 Demand-side substitution occurs because an increase in price makes a product less attractive to customers who therefore decide to purchase less of it and more of substitute products. A measure of demand-side substitutability, known as the elasticity of demand, looks at the responsiveness of demand to changes in price, with all the other prices remaining unchanged. Own-price elasticity measures the responsiveness of the demand for a product to a change in its own price; cross-price elasticity measures the responsiveness

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of demand for a product to a change in the price of a different product.[17] Estimates of such measures, where they are available, may be considered when defining the market.

2.16 The following are examples of the types of information that can be useful, when available, in the analysis of demand-side substitution:

- product characteristics such as physical properties and intended use;
- responses from customers, competitors and interested and informed third parties to questions about customer behaviour and the SSNIP test;
- information enabling the estimation of "switching costs" that customers might incur in changing from the product of one supplier to that of another. These may be monetary or non-monetary, eg the time, effort, uncertainty etc involved in switching suppliers;
- past and future business decisions. This may include documents such as marketing studies, consumer surveys, market analyses prepared for investors, and internal business analyses (eg board papers, business plans and strategy documents). The Commission will also consider any similar types of studies, such as surveys, that have been prepared specifically for the inquiry;
- available information on the extent to which variations in price differentials, over time or across different areas, have occurred and their impact on sales;
- estimates of own-price, and cross-price, elasticities of demand, for example from econometric studies, sales data etc.

This information may be supplemented with two calculations:

- estimates of the sales that must be lost before a given price increase would be unprofitable (sometimes referred to as 'critical loss'). This would then have to be judged against the likelihood of such a loss occurring;
- estimates of the maximum own-price elasticity of demand that would still make an increase in price profitable (sometimes referred to as 'critical elasticity').

Such calculations may help the Commission to judge how likely it is that a SSNIP would be profitable.

2.17 Various types of evidence on the responsiveness of customers to price changes may therefore be available to the Commission. Econometric estimates can provide information on elasticities, but their value depends on the robustness of the economic models used and the quality of the underlying data. Any econometric estimates submitted to the Commission should be supplemented by the full data set used, as well as a detailed description of each of the steps taken in the course of the estimation. This will help the Commission to understand fully the methodology used and allow it to replicate and assess the results.

2.18 Defining the market on the demand side focuses, as described above, on products rather than the firms that produce the products. However, as part of its wider assessment of competition the Commission will consider the separate

[17] An own-price elasticity of -1 means that a 5 per cent increase in the price of the product results in a 5 per cent decrease in the quantity sold of that product. Demand is said to be elastic when the own-price elasticity is less than one and inelastic when the elasticity is greater than one (ie closer to zero). Similarly a cross-price elasticity of +1 means that a 5 per cent increase in the price of product A results in a 5 per cent increase in the quantity sold of product B. For substitutes we would expect a positive cross-price elasticity (as an increase in the price of one good leads consumers to substitute to the alternative good). For complements we would expect a negative cross-price elasticity.

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issue of who produces the products included in the market. For instance, the importance of the market to a particular firm's sales or profits may affect that firm's attitude to, or strategy in, the market and may, therefore, be a matter the Commission will want to consider. In addition, the competitive strength of a particular firm may be related not only to its share of a market but to its overall size and financial strength.

(ii) Supply-side substitution

2.19 In defining the product market, the Commission will consider the potential for supply-side substitution, which occurs when a price rise prompts other firms to start supplying, at short notice, an effective substitute to the product in question. Supply-side substitution will usually come from firms with existing facilities, providing similar products and/or operating in adjacent areas. Imports might be another source of supply-side substitution.

2.20 It is not always straightforward to distinguish supply-side substitution from potential new entry. The difference is typically one of timing and/or investment: supply-side substitution occurs in the short-run with little or no investment required, whereas new entry is likely to occur over a longer period and may require more significant investment. Therefore, any significant investment or set-up costs, especially those which firms consider are unlikely to be recoverable, will reduce the likelihood of supply-side substitution. In order to consider a competitor's response as supply-side substitution, therefore, the response should, normally, be likely to occur within a year of the price rise (although the exact time period will depend on the nature of the market considered) and should not involve significant investment in plant, equipment, skills or marketing.

2.21 While the Commission will usually consider the extent to which supply-side substitution acts as a possible competitive constraint, and hence should be taken into account in defining the market, and will normally attempt to adjust market shares accordingly, it may not always be practicable to do so. The Commission will consider whether it is feasible to incorporate supply-side substitution into its calculation of the size of the market or whether it will calculate the size of the market based on the demand side only whilst incorporating in its assessment of competition in the market the fact that supply-side substitution imposes an effective competitive constraint on the incumbents.

2.22 The following are examples of the types of information that can be useful, when available, in the analysis of supply-side substitution:

- information on past supply-side substitution (for example, information on the extent to which supply-side substitution has resulted from variations in price differentials);
- information on the willingness of customers to switch to new suppliers following a SSNIP;
- information on the size of adjustment costs[18] for potential suppliers;
- information on the production processes involved;

[18] Adjustment costs are costs incurred in adjusting to the supply of the new product. For instance, they might include the costs of altering the production process or establishing the distribution of the product.

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- the extent of spare capacity within the industry;
- the business plans of potential suppliers and the assessment of their competitive threat by firms in the market;
- assessment by independent technical consultants and interested third parties of the likelihood and feasibility of supply-side substitution; and
- information on supply-side substitution in similar markets in other countries.

(b) Geographic market

2.23 The SSNIP test, including both demand and supply-side substitution, is also considered when defining the geographic market over which firms supply. The geographic market may be international, national, regional or limited to certain localities.

2.24 In considering the geographic market, the test looks at whether a SSNIP of the products in the relevant product market in a narrowly defined region would be profitable. If a SSNIP would not be profitable, for instance because customers switch to products in neighbouring areas, then these areas are added to the market and the procedure is repeated. The relevant market is defined as the smallest area in which a hypothetical monopolist could sustain a SSNIP profitably.

2.25 Where available, similar information to that used to identify demand-side substitution in the product market can be used to assess the geographical boundaries of the market. In particular the Commission might consider the following:

- the cost to customers of switching to products supplied in other geographic areas and the cost to suppliers of supplying products to different areas (eg transport costs) in relation to the value of the products and the length of time taken to make the switch;
- information on consumer preferences by area;
- product characteristics such as perishability;
- information on differences in pricing, sales, advertising and marketing strategies by area; and
- information on flows of goods between regions or into the UK and any legislative, natural, strategically created or other barriers to entry.

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2.26 The potential competitive impact of imports can also be analysed in the consideration of the geographic market, in the same way as that of UK based suppliers or potential entrants. Where a proportion of purchases within the United Kingdom is accounted for by imports, the Commission will consider whether customers would increase their purchases from overseas suppliers consequent upon an increase in domestic producers' prices (perhaps suggesting that the market is wider than the UK). Even when imports account for a small proportion of UK consumption, it might be relatively easy for the proportion to increase in response to a SSNIP, and the Commission will need to consider this as a possible outcome of the SSNIP. In some cases, however, there may be obstacles to customers purchasing more from overseas, or to overseas producers increasing their UK supply, for example, trade barriers, national standards, regulations or just capacity constraints. Furthermore, imports controlled in any way by the firms in the industry are unlikely to be a source of competitive challenge to participants in the market.

(c) Other aspects relevant to market definition

2.27 The Commission recognises the methodological and practical difficulties in delineating markets. These can be particularly acute, for example, in markets subject to rapid change, in markets driven by new technology, or in markets with other distinctive characteristics such as "bidding markets" where suppliers bid for the right to supply customers. This section looks at such factors and some other issues, such as chains of substitution, which are of relevance to market definition.

2.28 Some markets are not characterised by usual market attributes. For instance, bidding markets tend not to have multiple buyers and multiple sellers over a continuous time period; competition for contracts occurs at particular times only. Applying the SSNIP test in this instance might lead the Commission to consider each contract as a market in itself. This may not, however, be very helpful in understanding the dimensions of the market within which rivalry between firms occurs. In circumstances where the usual method of defining markets does not work effectively it may be necessary to consider other factors to help inform on market definition; for instance, information on the firms bidding for contracts and how they bid may be considered. It may also be necessary to consider other factors; for instance information on the track record of firms in bidding for contracts may be more indicative of the significance of firms in the market than other measures such as market share which might be difficult to calculate and perhaps misleading in such markets.

(i) Chains of substitution

2.29 In the process of defining a market, two products that are not direct substitutes can at times be included in the same market. This happens when product B, for example, is a direct substitute to products A and C, but C is not a direct substitute to A and vice versa. There is then a 'chain of substitution' running from A to B to C. Despite not being direct substitutes, A and C may, in some instances, be considered to be in the same market if they are constrained by their common relationship with B.

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2.30 In the presence of chains of substitution in the product market, consideration will be given to the extent to which there are breaks in the chain of substitution. Where, in using the SSNIP test, breaks in the chain of substitution are identified, it might be appropriate to define separate markets on either side of the break. In addition, consideration of the chain as a whole (and not simply each link) will be necessary in finally defining the market.

2.31 The concept of chains of substitution can also apply to geographic markets. The Commission will also consider possible breaks in the chain of substitution as well as the chain as a whole, in deciding whether separate regional or local markets should be defined. Where the concept of a chain of substitution leads to a wide geographic area, the Commission will also consider whether a hypothetical monopolist would be able to price discriminate between smaller areas, and if so, whether it is appropriate instead, to define a number of smaller geographic markets.

(ii) Different groups within a market

2.32 In many instances markets serve heterogeneous collections of customers, for example business and personal customers. Where this heterogeneity exists, and where suppliers can charge different prices to different groups, then depending on the market and the evidence presented, the Commission may choose to treat these different groups, for the purpose of assessing competitive pressures, as separate markets, or as one market whilst noting the scope for price discrimination between different groups within the market.[19]

2.33 As noted earlier (see paragraph 1.19), in some market investigation references there may be less than effective competition in certain aspects, or in some parts, of the market. This may divert competition into other areas of the market with firms using profits made in less competitive areas of the market to fund greater competitive effort elsewhere, for instance to sign up new customers. In some cases, if the less competitive area is sufficiently immune from competition elsewhere in the market, it may be, depending on the application of the SSNIP test, more appropriate to regard it as a separate market.

2.34 Temporal characteristics of demand may suggest that a market might be defined as comprising different groups of customers. When customers are not able to substitute products between periods, a temporal dimension may be added to the market, for example seasonality, peak and off-peak services. A typical example concerns commuters and leisure travellers on trains. Commuters constrained by their hours of work have less choice than other travellers and tend to travel at peak times. On the other hand, leisure travellers may be less sensitive to the time of travel and more willing to travel at off-peak times. Given this, train companies frequently charge higher prices during peak times than during off-peak times. In such instances, depending on the circumstances of the case, the Commission may decide to define two or more markets, or it may decide to define only one market and note the scope for price discrimination within the market, for instance identifying a market for rail travel with different prices charged to peak and off-peak travellers.

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[19] This scope for price discrimination over a narrow group of products within the market might allow a hypothetical monopolist to impose a SSNIP profitably over these products within a wider market.

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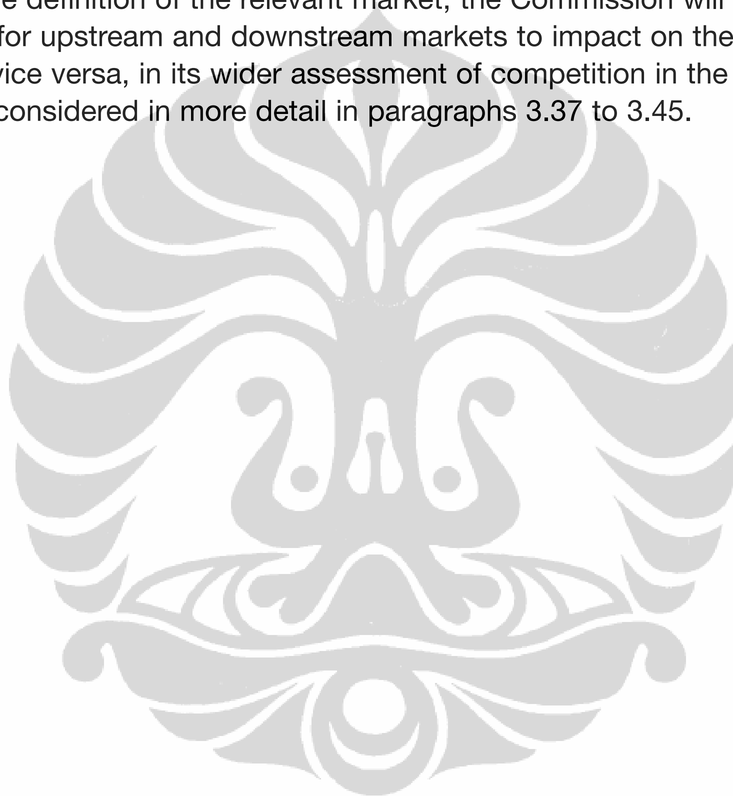
(iii) Upstream and downstream markets

2.35 Some products are not sold directly to the final customer. They are first sold to an intermediary, who then either sells on directly to another customer (wholesaler) or reprocesses the products before resale (reprocessor). Markets for products at an earlier stage of production are generally designated as upstream markets; and those at a later stage, typically the retail stage, downstream markets. There may be a supply chain involving one or more upstream markets in addition to the downstream market where the final consumer purchases.

2.36 Where there are upstream and/or downstream markets the Commission will have regard to their impact on market definition and competition more generally. As well as considering which aspects of the supply chain should be included in the definition of the relevant market, the Commission will consider the potential for upstream and downstream markets to impact on the relevant market, and vice versa, in its wider assessment of competition in the market. This issue is considered in more detail in paragraphs 3.37 to 3.45.



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Part 3: Assessment of competition

Introduction

3.1 Part 2 dealt with issues concerning market definition. This Part considers the assessment of competition in the market and whether there are any factors that might adversely effect competition. Factors that may have the effect of preventing, restricting or distorting competition can be structural features of the market, the conduct of firms whether as sellers or buyers, and the conduct of customers.

3.2 In the first instance, the Commission's analysis of competition in the market will typically include a consideration of rivalry from other firms within the market, the threat of entry and/or countervailing power of customers, but need not be restricted to these. The following section deals with structural factors relevant to intra-market rivalry before considering other competitive constraints on firms such as barriers to entry and countervailing buyer power. It then turns to other aspects of the market that might need consideration in a market inquiry such as vertical integration and the conduct of customers. It then looks at the conduct of firms and its impact on intra-market rivalry before considering some possible indicators of ineffective competition.

Intra-market rivalry

3.3 The process of intra-market rivalry is altered by both the conduct of firms in the market and structural features of the market. The following section considers the structural features pertinent to intra-market rivalry; a later section considers the conduct of firms.

(a) Intra-market rivalry: structural features

(i) Market shares and concentration

3.4 The market shares of firms in the market, both in absolute terms and relative to each other, can give an indication of the extent of a firm's market power. For instance, a firm with a large market share relative to other firms in the same market may have the ability to raise its price independently of other firms, at least to some extent. Further, a large market share may confer substantial advantages in bargaining with suppliers upstream, or buyers downstream, and a firm may be able to control prices in its favour or impose unreasonable restraints in the negotiation process. However, a firm with a large market share will not always be able to exert market power. Other features of the market, such as the extent of switching costs, threats of entry and countervailing buyer power, will affect a firm's ability to exercise its market power.

3.5 As noted earlier, it is likely to be unusual for market investigation references to be focused solely on a single firm. Nevertheless, there may be cases where the size and conduct of a large single firm has a significant impact on the market. In such instances the Commission might wish to investigate the firm's behaviour in more detail.

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3.6 More generally, changes in market shares over time may give some indication of the dynamics of the market and may be useful in assessing the nature and extent of competition in the market. When considering such changes, the Commission will aim to look at market shares over several years where the information is available. Volatile market shares may indicate the existence of effective competitive constraints against the exercise of market power in the form of, for example, successful entry, rivalry between firms and innovation. However, high and static market shares do not always indicate that a firm has market power: the firm may simply have competed successfully on a continuing basis.

3.7 In order to calculate market shares, the Commission may use information from a variety of sources including the main parties, other competitors, customers, buyers, suppliers, trade associations and market research reports. Market shares can be measured in terms of revenues, volumes, production capacities or inputs, depending on the markets concerned and the information available.

- ***Concentration measures***

3.8 Normally the Commission will also look at measures of the degree of concentration of the market (which are primarily measures of the structure of the market). Concentration measures can be indicators of the ability of the leading firms in a market to exercise market power collectively, though other competitive constraints will need to be considered before finding that firms have such market power.

3.9 There are a number of possible ways of measuring the degree of concentration in a market. A straightforward count of the firms in a market is only a very basic measure of concentration because it does not convey much information about the structure of the market – it fails to take into account differences in market shares and the size distribution of firms. Two other measures that are commonly used are the concentration ratio and the Herfindahl-Hirschman Index (HHI).

3.10 The concentration ratio measures the combined market share of the largest firms in a market. For example, the 'five firm' concentration ratio is simply the sum of the market shares of the five largest firms in the market. As such, it does not provide any information on the relative size of the firms nor on the number, or size, of the smaller firms.

3.11 In contrast to the concentration ratio, the HHI potentially reflects both the number of firms in the industry and their relative size. It is defined as the sum of the squares of all the market shares in the market. In its guidelines, the OFT states that it is likely to regard any market with a HHI in excess of 1800 as highly concentrated, and any market with a HHI in excess of 1000 as concentrated. Where it uses the HHI, the Commission will have regard to the threshold levels set out above, but only as one factor in its wider assessment of competition.

(ii) Other structural factors

3.12 Whilst market shares and other measures of concentration may provide an indication of current competitive conditions within a market, the Commission will consider a number of other factors in its assessment of competition in the market. Future market shares might be very different, for example due

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to technological change, the existence of patents and the development of new products. Such factors may suggest that future competitive conditions are likely to be different from those suggested by simple market share or concentration measures.

3.13 Moreover, there are a number of other structural factors beyond market shares and market concentration that can affect the degree of intra-market rivalry in a market. For instance, the extent of intra-market rivalry may depend on whether firms' cost structures are very similar or not, and how low-cost firms utilise this advantage. In addition the degree of spare capacity in a market and the ease with which existing capacity can be expanded are two factors that might impinge on the degree of intra-market rivalry. Furthermore, the ownership and organisational form of firms might also affect the degree of intra-market rivalry.

3.14 Particular features can be important in some markets; for example, certain markets are characterised by network effects. Such effects arise when the value of a product to a customer increases with the number of other customers consuming the same good. As a result, incumbents with an existing customer base have an automatic advantage over entrants. Markets characterised by network effects may be prone to 'tipping'. That is, as one firm, or technology, gains an advantage in the market, in effect, the balance of power in the market 'tips' in its direction leaving it as the prevalent firm, or technology. An example of this was the emergence of VHS developed by JVC as the standard video technology over Sony's Betamax at the beginning of the 1980s. In these markets, competition takes place for the market as opposed to within the market, and traditional methods of analysis, such as market shares and market concentration, might not adequately convey the degree of competition in the market.

3.15 Two other factors that might impinge on intra-market rivalry are switching costs and information asymmetries. These factors along with their interaction with the conduct of customers are considered later (paragraphs 3.46 to 3.55).

(b) Barriers to entry, expansion and exit

3.16 Where the Commission believes that intra-market rivalry is not strong, other possible competitive constraints on firms need to be considered. This section considers the potential for entry and expansion in the market. It looks at entry and expansion in general before focusing on different types of barrier such as natural or intrinsic barriers, regulatory barriers and strategic barriers. It then considers the effects of entry before turning to countervailing buyer power – another possible competitive constraint.

3.17 The threat of entry or expansion can act as a constraint, preventing firms from exercising market power. Adverse effects on competition are thus less likely where entry is easy, provided that such entry is sustainable and likely to have an impact on the potential for existing firms to exercise market power.

3.18 Entry and expansion might take a number of forms including, for example:

- new firms building new capacity;
- existing firms within the market building new plants or capacity;
- forward/backward integration;

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- the entry of new firms into the market taking over existing capacity and using it in new, or more productive, ways; and
- new technology facilitating new production methods, potentially increasing entry possibilities.

3.19 In assessing the potential for entry to act as a competitive constraint, the Commission will consider available information on a number of factors including:

- the history of past entry and evidence of planned entry or expansion by third parties;
- the extent to which past entrants have successfully gained market share and, more generally, the cost of gaining a significant share of the relevant market (usually considered as 5 per cent);
- direct observations or statistical information on barriers to entry, expansion and exit;
- the costs involved in entry or expansion and in operating at the minimum efficient scale necessary to achieve a reasonably competitive level of costs;
- the likelihood of entry (from new entrants in related markets and/or from scratch) or expansion within such a timescale that it bears on the incentives and decisions of the existing firms in the market;
- the cost of exiting the market – if this is high it may deter entry by raising the cost of failure for new firms;
- the potential effect of technological change and innovation on barriers to entry or expansion; and
- the likely response to entry or expansion by incumbent firms.

3.20 In considering historical evidence, relevant factors include survival rates, ie how long any entrants traded in the market; the effects that entry or expansion had on competition in the market, in particular whether past entry or expansion modified the pattern of behaviour and competition; and if so, whether this would be relevant for the present analysis.

3.21 The effectiveness of any given set of barriers to entry or expansion will to some extent depend on other characteristics of the market. For instance, if growth in demand is likely to be large and/or rapid, then barriers to entry are less likely to have a lasting effect. Similarly, in markets characterised by innovation, product cycles are likely to be shorter, which may decrease the probability that some barriers to entry will have a lasting effect. More generally, therefore, the Commission will consider what other supply-side responses might be likely.

3.22 Barriers to entry are features of the market that may prevent or restrict firms from exploiting profitable opportunities in a market and hence enable existing suppliers to raise prices above costs persistently without significant loss of market share. Some barriers are described as “natural” or “intrinsic” in the sense that they are a function of the technology, production methods or some other factor necessary to establish an effective presence in the market. Some are “regulatory”, such as rules designed to provide safety, or other types of

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consumer protection that may make it difficult for new firms to develop products. It should be noted that the concept of regulation in this case is broader than the conventional sense and includes things such as intellectual property law, the planning regime, voluntary or compulsory standards and codes of practice for example. Other barriers, termed “strategic”, are the result of existing firms in the market acting with the specific intention to deter entry or expansion. Each of these different types of barrier is considered in more detail in the following sections.

(i) Natural or intrinsic barriers to entry or expansion

3.23 Natural or intrinsic barriers to entry or expansion are the unavoidable costs necessarily incurred when setting up or expanding a commercial operation. These involve the cost of putting the production process in place, gaining access to essential facilities or inputs and the acquisition of any necessary intellectual property rights (IPRs). An important consideration in evaluating the effects of such barriers is the extent to which the costs associated with them are ‘sunk’.

3.24 Sunk costs are those costs that cannot be recovered fully upon exit, because they cannot be used to produce other goods and cannot be successfully traded. They include for example, some specific asset investments, advertising, and research and development (R&D). In some markets, a reputation for producing quality products is needed to attract customers: the costs of acquiring such a reputation can be a form of sunk costs. As noted earlier, the existence of high sunk costs is likely to deter entry by raising the costs of leaving the market. Non-sunk costs, in contrast, by definition are recoverable if production ceases, and do not therefore pose the same risk.

3.25 In industries where economies of scale are significant, entry or expansion on a small scale may not be economically feasible unless the firm is aiming at a differentiated ‘niche’ in the market or can develop a new production strategy which offsets the disadvantages of small-scale production. But entry or expansion on a large scale will often raise the risks because large-scale entry or expansion will generally be successful only if the firm can expand the total market significantly, or substantially replace one or more existing firms. Firms can also be at a disadvantage where production costs are reduced according to the cumulative quantity produced (ie through ‘learning by doing’). Similar considerations apply to economies of scope, which arise where producing two (or more) products is less costly for a single firm than for two (or more) firms each to produce the products separately. Where economies of scope are significant, a successful entrant might have to produce a range of products from the outset.

3.26 Where substantial financing is required for entry or expansion, the Commission might want to consider whether raising capital to finance the set up of a new operation is difficult and whether the actual cost of financing would be relatively high. Financiers might regard new entrants as especially high risk because they do not have a proven track record in the market and consequently provide higher cost finance to new entrants as opposed to incumbent firms.

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3.27 Existing firms within the market sometimes have access to superior or scarce resources to which entrants cannot gain access because the supply is limited, or the cost prohibitive. This might again act as a barrier to entry by, in effect, raising the input cost to entrants relative to existing firms.

3.28 Natural or intrinsic barriers to entry often accrue simply because incumbents are already in the market and as a result have a cost, or demand-side, advantage over entrants. Alternatively, incumbent firms may derive some benefit from simply being a known business in the market and as such there may be a reputational barrier that new entrants would have to overcome. In addition, a firm will often have to incur costs to launch a product in order to gain consumer awareness and this can act as a barrier to entry. The existence of switching costs may also increase the costs of entry, making it harder to gain customers from the incumbents' existing customer base. In some markets the first firm to innovate or introduce a product or create a substantial capital base will gain a competitive advantage which competitors can overcome only with difficulty.

3.29 Network effects (paragraph 3.14) may constitute an absolute barrier to entry as incumbents with an existing customer base have an automatic advantage over entrants. However, when demand is growing fast, or innovation is rapid, the barrier might not be as high as when demand or technological change is more static.

(ii) Regulatory barriers to entry

3.30 Regulations are beneficial for a variety of reasons ranging from ensuring the stability of the financial system to protecting the environment. Notwithstanding this, regulation may inhibit the extent to which competition can flourish in certain circumstances. Some types of regulations may concern the production process and the characteristics of the finished product, for instance health and safety standards. Others may limit the number of competitors in the market, for example by requiring that only firms with a licence or permit may operate in the market. A limitation on the number of licences and permits may act as an absolute barrier to entry. If licences and permits can be traded in a competitive market, then a potential entrant could enter the market by buying a licence, though this would depend on how frequently such opportunities arose.

3.31 Subsidies, tax relief and preferential purchasing may also raise barriers to entry in a market if potential entrants are not equally eligible for them. Similarly, planning policies and regulations can constitute a barrier or impediment to potential entrants into a market to advantage of incumbent firms. Intellectual property rights (IPRs) such as patents, trademarks and copyrights give the owners of such rights exclusive use of them and the ability to control their use by others, though the period of such exclusivity or control varies according to the nature of the property right. Whilst IPRs are a way by which firms and individuals are incentivised to invest and innovate they can also act as barriers to entry, as access to certain rights owned by an incumbent may be vital for entry. In some such cases it will be more appropriate to assess the impact on competition for the market rather than within the market.

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3.32 Quality, environmental, and health and safety standards that apply indiscriminately to all the firms in a market may on occasions adversely affect entry although they make no distinction between incumbents and new entrants. For example, they might favour the technology which the incumbent owns and in so doing raise the costs of a new entrant. Some regulations may give advantage to incumbents by not requiring them to comply with the same standards as new entrants. For example, existing high pollution factories often have grandfather rights to pollute, which are not enjoyed by entrants, because the factory existed before the relevant regulation came into force.

(iii) Strategic barriers to entry

3.33 Firms that are already operating in the market may sometimes have the ability to pursue strategies designed to deter entry through investing in excess capacity or launching predatory price or non-price initiatives targeted at entrants when they are most vulnerable. Switching costs, for instance, may be intrinsic to the market, but may also be affected by the actions of firms. The existence of significant switching costs may act as a barrier to entry, especially when there are economies of scale. Firms may act to increase such switching costs, so strategically raising barriers to entry, for example by offering fidelity discounts. Furthermore, existing firms may produce complementary goods and tie or bundle them together, which potentially raises the costs for an entrant who produces only one of the complementary goods.

3.34 Other forms of non-price competition, such as advertising, can have the effect of increasing sunk costs, and this will tend to disadvantage entrants. Even a low level of sunk cost may be enough to deter entry given that existing firms within the market have already incurred these costs. They may also be able to deter entry by signalling that they would respond aggressively to entry or seek to target entrants specifically to drive them back out of the market. Similarly, incumbent firms may seek to deter expansion by another firm in the market.

3.35 Sometimes firms may, through their conduct, increase barriers to entry even though that may not be the prime purpose of their conduct. Marketing or advertising, for instance, may be designed for inter-firm competition but may make entry more difficult. More generally, firms often seek to create a reputation for good service, quality and reliability and this may prove a further obstacle to new firms seeking to enter the market (with no track record to demonstrate their quality and reliability for example). In market investigation references, when applying the AEC test (paragraph 1.5), the Commission will take into account that firms may have built market share by successfully providing customers with good service, quality and value for money. It will, however, also have regard to the impact on competition and barriers to entry.

(iv) Effects of entry and expansion

3.36 The absence of significant barriers to entry and expansion will tend to constrain what might otherwise be scope for the exercise of market power by incumbent firms. However, the Commission will wish to consider not only whether entry or expansion can be expected to occur within such a time scale that it bears on the incentives and decisions of the existing firms in the market but also whether successful entry or expansion can be expected to be sustainable or provide an effective competitive constraint to firms in the market. In some cases entry on a

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small scale may be relatively easy, for example using a small-scale technology, but there may nonetheless be considerable barriers to expansion to a scale that would significantly impact on competition. Similarly, entry of firms producing niche products will not necessarily constrain incumbent firms' ability to exercise their market power. In markets with differentiated products, entry at the fringe may be easy, but a niche product may not necessarily compete strongly with other products in the same market and so constrain incumbents effectively.

(c) Countervailing buyer power

3.37 In many markets buyers have some degree of market power. Prices will then be determined by their relative bargaining power. Buyers may have sufficient bargaining power to prevent the exercise of suppliers' market power. Much depends on the relative importance to each of its business with the other party. In retailing, for example, a supplier may well be more dependent on his sales to a large retailer than is the retailer on its purchases from that supplier, even if the supplier has a larger market share of its market than the retailer has of the retail market.

3.38 The fact that the market is characterised by buyers that are large relative to the size of the suppliers does not necessarily mean that there is countervailing buyer power in the market. For instance, factors that will affect the ability of buyers to constrain suppliers include:

- the buyers' ability to find alternative suppliers in the case of a price rise;
- the ease with which buyers can switch supplier;
- the extent to which buyers possess a credible threat of setting up their own supply arrangements;
- the extent to which buyers can credibly threaten to stop purchasing other products sourced from the supplier; and
- the extent to which buyers can impose costs on suppliers (for instance by delaying purchases).

3.39 While buyer power can offset the market power of suppliers, the benefits from the exercise of buyer power in lowering suppliers' prices are not necessarily passed on to their customers. Much depends on how effective competition is between the various buyers in the market that they supply. It follows that, in markets where buyers appear to have market power in their own right, the Commission's assessment of whether any market feature has the effect of preventing, restricting or distorting competition is likely to have to embrace the competitive process in both the upstream and the downstream markets.

(d) Supplier power

3.40 In some situations, the structure or behaviour of firms in upstream markets may have an appreciable effect on downstream markets subject to a market investigation. For instance, upstream suppliers may possess many of the characteristics of power outlined for buyers above. In such circumstances the Commission will have regard to the upstream market and its effect on the

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market subject to the reference. Normally it would be for the OFT to consider whether any concerns arising in the upstream market itself were sufficient to justify a separate reference.

(e) Vertical integration

3.41 A vertically integrated firm operates simultaneously at different levels of the supply chain for a particular product or service. Vertical integration thus modifies the structure of a market as it adds a dimension to the relationship between competitors. It may be distinguished from vertical agreements between firms, which are considered later as an aspect of firms' conduct. The effects of vertical integration can be ambiguous. It can lead to gains in efficiencies that would not be achieved without integration, but it may also lead to the foreclosure of supply to non-integrated firms and higher barriers to entry.

3.42 Examples of efficiency improvements from vertical integration include improved organisation between firms at different stages in the supply chain, resulting in, for instance, improved product design, lower transaction costs and removal of the 'double marginalisation' that occurs when two non-integrated firms both have significant market power.[20] Another potential benefit of vertical integration is that it can create greater confidence for specific investments when market contracts provide inadequate incentives and safeguards.

3.43 Vertical integration can also have anti-competitive effects, most notably if rival firms downstream are not supplied (known as 'foreclosure' of supply), for example, when retailers are integrated with manufacturers and only sell the goods of their parent company. Although this may reduce costs for the supplier because the manufacturer has to supply fewer retailers, it decreases inter-brand competition within each retail outlet.

3.44 Vertical integration can raise barriers to entry or expansion, for example by limiting, or foreclosing altogether, access to essential inputs or means of distribution to a non-integrated firm, or by requiring any entrant to consider entering at both stages.

3.45 The larger the share of either the upstream or the downstream market of the vertically integrated firm, or the more widespread the vertical integration in a market, the more significant the effects of vertical integration are likely to be.

(f) Switching costs

3.46 In some markets, customers face obstacles to switching between suppliers. These may take many forms including inconvenience, monetary costs, administrative hurdles or a lack of information about the products of alternative suppliers. The existence of switching costs may mean that suppliers can charge high prices to captive customers and this may have implications for market definition as well as for the assessment of competition. Against this, the presence of switching costs may intensify the competition for new customers, which may benefit new buyers, particularly if there is scope to charge rather different prices to new as opposed to existing customers. The overall effect on competition will depend on weighing up these effects. Much the same set of considerations applies where there are network effects, since these effectively give rise to collective switching costs, locking consumers into existing standards and the firms that control them.

[20] Double marginalisation may occur because, in the absence of price discrimination, each non-integrated firm has the incentive to raise prices above cost without taking account of the fact that this lowers the output of the other. The result is lower output and profits (and higher prices) than if the two firms pursued a policy of joint profit maximisation.

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3.47 The Act explicitly includes the conduct of customers as a market feature that might potentially adversely effect competition. As indicated above, switching costs may decrease customers' incentives to search for, or switch to, alternatives that could meet their needs. Evidence that customers rarely switch suppliers, combined with evidence that significant switching costs exist, may suggest that competition is not effective.

3.48 Technical standards can lower switching costs, for example, by ensuring the compatibility of different suppliers' products. But they could have adverse effects on competition if they serve to discourage market entry. This may happen if the standards favour incumbents. For example, entrants may only be able to gain access at prohibitive cost to crucial patents or know-how held by incumbents.

(g) Information asymmetries

3.49 Customers' purchasing decisions are based on the information they have about products. Complete information would include knowledge of all available substitutes and their characteristics, their prices, and the switching costs that customers incur in changing suppliers. The characteristics of a product include all the things that the customer values such as durability, functionality, compatibility, etc. Firms in markets with well-informed customers have the incentive to supply goods that match the preferences of customers, as customers could take their business elsewhere if other suppliers were matching their preferences more closely.

3.50 In many markets, customers do not have adequate information: information may be unavailable or costly to acquire or customers may be unwilling or unable to get it. In such markets, customers can only compare prices or the quality of the products they know, or are aware of, and thus their perspective of the market is reduced. Firms may exploit this gap in knowledge and compete less intensively on prices or quality because, regardless of the actual number of suppliers in the market, customers are unlikely to switch to other products readily.

3.51 As noted in paragraph 1.18, the Act explicitly includes the conduct of customers as a market feature that might adversely affect competition. Information asymmetries may be one area where this issue is relevant as information asymmetries decrease customers' incentives to search for or switch to alternatives that could meet their needs. Evidence that customers do not search out alternatives effectively, combined with the evidence on the existence of information asymmetries may suggest that competition is not effective.

3.52 It is often the case that customers are unable to assess the quality of a product fully before making a decision to purchase. This can occur, for example, when products are complex, when the performance of a product is not easily determined prior to sale, or when products are purchased infrequently. In such circumstances, where purchasers have less information than sellers regarding the quality of the products, the competitive process can be significantly affected. Information asymmetries of this type can, in the absence of corrective measures, distort market behaviour. Indeed, in principle, such problems could lead to difficulties in even establishing a market for the product. In theory this

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problem could apply to any market where there are asymmetries in information, for example, many durable goods, insurance services, health services, legal services, estate agency services, and holidays. The effects of asymmetric information may, however, be mitigated in various ways. For example, in the case of holidays, suppliers might offer 'satisfaction guarantees' on their holidays, or produce more detailed brochures describing the accommodation. These 'mitigating factors' frequently become part of the process of competition, though they may not overcome the information problems entirely.

3.53 Advertising is often an important source of information for consumers, but can have an ambiguous effect on information asymmetries. Advertising and promotional offers increase the visibility of a product and provide information on price, where it can be bought and so on. However advertising may not necessarily be informative in terms of what consumers want to know about a product; rather it may contain only what firms feel consumers need to know in order to persuade more of them to buy the product.

3.54 Firms may engage in practices that increase search and switching costs by, for example, providing inadequate information about prices. Prices may not be clearly displayed, or firms may only refer to some prices (eg special offers etc) which are not always available to all customers. In some cases, a large amount of information may be made available but is complex or displayed unclearly so as to limit customers' understanding of existing prices.

3.55 It is important to add that information asymmetries might have adverse effects on competition even when other structural features such as the number of firms and entry conditions suggest that the market may be competitive. This is likely to be the case in markets for services where customers are not able to gauge the quality of a service when acquiring it.

(h) Intra-market rivalry: conduct

3.56 As noted earlier, there is more to the assessment of intra-market rivalry than purely structural features. Markets with a similar structure can display different degrees of intra-market rivalry as a result of many factors. Non-structural factors that might affect the level of intra-market rivalry can include, for example, the different ability of, and capacity for, firms to innovate; the objectives and culture of the firms in the market, their views on the future development of the market and on the appropriate strategies to meet those developments; the history of pricing behaviour in the market and the extent to which transparent prices are available in the market. To the extent that these can be identified during the course of an inquiry, these factors might well provide additional insight to the more static analysis of market structure.

3.57 In short, the Commission will seek to assess the process of competition and consider the kinds of factors that determine its effectiveness. But it is to be emphasised that there can be no exhaustive or inclusive list of the types of conduct which might adversely affect competition, much less the assurance that a particular pattern of conduct will adversely affect competition in all market circumstances. The Commission will have regard to any conduct of the firms in a market (whether sellers or buyers) that could, in the circumstances of the particular market, have an adverse effect on competition (whether in the market in which the firms themselves are engaged or in some other market, for example,

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the market of the sellers' suppliers or customers). The rest of this section looks at the pricing strategies of firms and non-price competition before considering other conduct that can affect the extent of competition within a market.

(i) Pricing issues: coordinated effects

3.58 Where markets are sufficiently concentrated, the actions of individual firms can have identifiable effects on their competitors, such that firms recognise their interdependence. The interdependence of oligopolistic firms may lead them to anticipate competitors' responses to their own actions and take this into account in their own decisions. If, as will often be the case, this interdependence persists through time in such markets, the repeated nature of such decisions can have significant effects on business strategies and on competition. In particular, under certain conditions discussed below, it can become rational to refrain from initiating price cuts which would be unavoidable in more competitive circumstances.

3.59 If a reduction in price fails to achieve a significant volume response it will be unprofitable. However, if it does achieve such a response this will, in a sufficiently concentrated market, be likely to provoke a matching price reduction from the competitors who will necessarily have lost significant demand. In this instance, the price cut will again prove to be unprofitable. Recognition of this – namely that firms have a clear common interest in avoiding mutually destructive price cuts – may be sufficient to deter a cut in price.

3.60 Moreover, price increases by one firm to levels that might otherwise have been uncompetitive may well prove profitable. This is because, of the two possible responses by competitors – to follow or not to follow the price rise – the former will often be more profitable, as the latter is likely to force a reversal of the original price increase and hence eliminate the new profit opportunity. Recognition of this could then provide rational grounds for the initial price rise. Such considerations, whether explicit or implicit in terms of established pricing strategies, understanding of 'going rates' etc can result in oligopolistic firms tending to match each others' prices at a higher level than could otherwise be sustained.

3.61 This type of behaviour is sometimes referred to as 'tacit collusion' or 'conscious parallelism'. However, this behaviour does not require any type of collusion, in the usual sense of the word, between firms, or even any contact between them. Nor does any such parallelism of price necessarily have to be 'conscious' in the form of an explicit or documented analysis of interdependent price strategies. Instead, the behaviour can arise purely from firms' perception of interdependence, with the benefits of such behaviour accruing to all firms in the market. As a result, we term the effects of such behaviour coordinated effects, whilst noting that no explicit coordination between firms is necessarily required. Such behaviour is nonetheless capable of weakening competitive pressures on prices and, if so, is likely to be detrimental to both consumers and the extent of rivalry in a market.

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- ***Conditions facilitating coordinated effects***

3.62 A number of conditions are necessary for such behaviour to occur and be sustainable through time. First, the market has to be sufficiently concentrated for firms to be aware of the behaviour of their competitors, and for any significant deviation from the prevailing behaviour by a firm to be observed by other firms in the market. Where prices are transparent any deviation from the prevailing behaviour will be clear. However, even where they are not transparent, as is often the case in intermediate markets, any deviation from the prevailing behaviour by a competitor may nonetheless be readily apparent, because the essence of interdependence is that price cuts by one firm will have a significant impact on others' volumes.

3.63 Secondly, it must be clear that it will be costly for firms to deviate from the prevailing behaviour; so costly that it will be in a firm's interests to go along with the prevailing behaviour rather than seek to deviate from it. In many cases, the mere fact of the interdependence and hence the strong likelihood of a matching price cut may be enough to create such a disincentive. Timing will, however, be significant here. If prices can be adjusted quickly then such a response is very likely, but in markets where prices can only be set infrequently, the short-term gains from lower prices until a response is possible could outweigh the long-term gains of higher oligopolistic prices. If price setting is very infrequent then the basic perception of interdependence may cease to hold at all.

3.64 Thirdly, this type of parallelism can only be sustained in markets where there are relatively weak competitive constraints. If barriers to entry are low, then the threat of entry will tend to undermine such conduct. Alternatively, if there is a fringe of other firms in a market outside the core oligopolists, and if the competitive fringe firms have both the incentive to undercut and scope to attract significant volume away from the core oligopolists, then an uncompetitive price level is unlikely to be sustainable.[21]

3.65 The extent to which fringe firms act as a competitive constraint will in part depend on the number and size of such fringe companies and their cost and profit margins. It will also depend critically on their scope to expand output, first in relation to their current levels and secondly in relation to the output of the core oligopolists. To the extent that fringe firms can significantly expand their own output, their existence will provide a threat to firms considering pricing above competitive levels. If however this scope is limited then pricing up to the 'umbrella' price set by the core oligopoly may be more profitable. Even if a lower price strategy for the fringe firms is preferable (to pricing up to the 'umbrella' price) this will only tend to undermine the prevailing price level if the loss of output by core companies to the fringe is sufficiently large in relation to the output of the core oligopolists. It should be noted that such behaviour, and so coordinated effects, could also occur with non-price variables such as quality, variety and innovation.

3.66 The Commission will want to evaluate all the available information on the characteristics of the market that may facilitate, or may in other ways impinge upon, coordinated effects. These can include:

- a high level of concentration in the market;

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[21] The term "competitive fringe" is often used by economists to describe a group of relatively small firms in the market.

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- the existence and significance of entry barriers;
- evidence of a long-term commitment to the market by firms;
- a high degree of homogeneity of the firms' products;
- a high degree of homogeneity of firms (ie the extent to which firms are similar, for instance, with respect to their size, market shares, cost structures, business strategies and attitudes to risk);
- a high degree of market transparency (the more transparent the market the easier it is for firms to see each other's actions);
- the existence of institutions and practices that may aid coordination, for example information sharing agreements, trade associations, regulations etc;
- the existence of switching costs. (However, in some instances, switching costs might increase competitive pressure so destabilising any coordination);
- the degree of excess capacity in the market (for instance a high level of excess capacity might make coordinated behaviour more difficult as other firms might enter and use the excess capacity. However, in other instances, excess capacity may make coordination easier because firms could use the spare capacity as a credible threat to other firms thinking of deviating from the prevailing behaviour);
- the stability of demand and costs (unpredictable changes in demand or costs might make it more difficult for firms to decipher whether a change in volume sold, for instance, is due to the actions of another firm or due to demand changes in the market as a whole);
- the stability of market shares over time;
- short-term financial pressures on firms (short-term financial pressures may encourage firms to depart from any common pattern of long-term behaviour);
- the extent to which small firms on the fringe of the market, for example, producing specialist 'niche' products might embark on large scale or more developed production.
- The extent to which there is strategic intervention by interested third parties (buyers and suppliers for example);
- The scope for, or pressure on, firms to bring new products into the market.

The Commission will seek to assess how in the circumstances of the investigation, the factors above interact to make coordinated effects more or less likely.

3.67 One problem in identifying such conduct is that similar or identical prices can also result from intense competition. Therefore, the observation that prices are similar, and even that they tend to move together, does not of itself demonstrate oligopolistic pricing of the type described above. Indicators or ways of distinguishing intense competition and oligopoly pricing include, first, the level of profitability generated by the price levels established. If profits are

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excessive then this might be an indicator of oligopoly pricing. A second indicator might be that prices in competitive conditions, though tending to the same level, are, over time, likely to exhibit significant variation as they respond to changing supply and demand conditions. This is less likely to be the case with oligopoly pricing, because the incentive not to depart from an established level of high prices will to some extent dampen the responsiveness of prices to costs and demand changes. Indicators of the extent of competition are considered in more detail in paragraphs 3.78 to 3.90.

(ii) Non-price factors in competition

3.68 As noted earlier, rivalry encompasses both price and non-price competition, and the latter can in some markets be more significant than the former. Where applicable, the Commission will consider the effect of non-price competition in a market, for example product development, product range and quality, marketing, servicing, and R&D. An emphasis on non-price competition may reflect the characteristics of the product or customer, but may also result from incentives not to compete on price alone or a desire to raise barriers to entry. Equally, if strong non-price competition in the relevant market leads to substantial product differentiation, then this may mean that coordinated price behaviour is more difficult or impossible to achieve. Separately, strong product differentiation may facilitate price discrimination.

3.69 However, just as there may be factors reducing the level of price competition, there may be similar or other ones that reduce the extent of non-price competition. Oligopolistic firms may each have an incentive to delay introducing new product developments if this would precipitate equivalent development from competitors, thereby undermining the profitability of the existing product range. However, as in the case of coordinated price effects, the strength of this incentive will generally depend on how quickly it is anticipated that competitors could respond. If a long time-lag is envisaged then the threat to existing profitability is more likely to be discounted. Firms may also avoid competing in the same geographic markets, or refrain from competing with very similar products.

3.70 Whilst non-price competition that leads to product differentiation may make coordinated behaviour less likely, it may also segment the market, facilitating price discrimination schemes that may act to the detriment of the consumer.

3.71 Advertising is a significant form of non-price competition and in many instances may act to increase information about products for consumers. However, notably in concentrated markets for consumer goods, the Commission will consider whether advertising is excessive and whether it is simply being used to support brands at high prices (or margins) and/or with the possible effect of increasing entry barriers. In this instance the Commission will consider whether the resources used in advertising might better serve competition through other means, for instance direct price cuts.

(iii) Other market-wide horizontal conduct

3.72 There may be other market-wide practices that are adopted as custom and practice in a particular market and without agreement, communication or contact between competitors. Examples include manufacturers' recommended retail prices and fees

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charged by underwriters of new issues on the capital market. Another example is the widespread adoption of tying practices in a number of markets ranging from computers and office equipment to the insurance and travel trades. There may be objective justifications for such practices, but any common policy among competitors will raise the question of whether competition is adversely affected.

3.73 Market-wide practices may also be the result of adherence to the recommendations of a trade or professional body or indeed to Government regulations. Again such conduct could be investigated for possible adverse effects on competition.

3.74 Competition may also be adversely affected in a market as a whole where information asymmetries, switching and search costs are important. Such market features will tend to give suppliers a degree of market power. Suppliers may also reinforce the impact of such features by providing misleading product or price information or by limiting information that would be useful to customers' decision-making.

3.75 The Commission may assess the effects on competition of certain forms of discounts and rebates. In many cases, discounts and rebates are normal components of the competitive process and will, in general, not be a cause for concern. However, where a firm, or group of firms, has market power then the Commission will consider whether any discounts or rebates offered might have adverse effects on competition. It is unlikely that, for example, short-term discount programmes and cost-based volume discounts open to all customers will raise concerns. In addition, discounts may be one way in which coordinated behaviour between firms might be broken down. However, there could be circumstances where the opportunity to negotiate an individual discount provides a way of responding to pressure for lower prices from particular buyers and hence of maintaining coordinated prices across the rest of the market. In addition, other forms of discounts such as fidelity (or loyalty) discounts, which directly disadvantage other suppliers, may hinder competition.

(g) Vertical agreements

3.76 Vertical agreements such as exclusive dealing arrangements or selective distribution arrangements may have beneficial or adverse effects on competition depending on the specific circumstances of a market. One beneficial effect can occur where a supplier wants distributors to provide advice, stock spare parts, or make investments, whether in facilities, equipment or marketing which will promote the product. This may enhance competition and consumer satisfaction, but represent too costly a commitment by distributors without some assurance of adequate sales.

3.77 Against this, such agreements have the effect of foreclosing access by other manufacturers to the part of the market covered by them. The effect of this will depend in part on the proportion of the market foreclosed, the length of time before such agreements are renegotiated, and the scope for other distributors to enter the downstream market and provide alternative outlets to other manufacturers. The effect of selective distribution arrangements will also depend on the criteria used to select distributors and whether there is a quantitative limit on the number permitted.

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Indicators of the extent of competition

3.78 The Commission will often not reach a conclusion on whether there are adverse effects on competition or whether there have been detrimental effects on customers solely from the investigation of structural and conduct features of a market. It will normally be helpful to the Commission's assessment to consider the effectiveness of competition by examining the outcome of the competitive process in the particular market. To do this the Commission will consider various other indicators of the extent of competition.

(a) Prices

3.79 One such indicator is the pattern of price changes over time. For example, as mentioned in the context of oligopoly pricing, evidence of parallel movements in prices may, where other market characteristics are conducive to such behaviour, indicate coordinated behaviour and an absence of effective competition. Prices in competitive conditions, though tending to the same level, are, over time, likely to exhibit significant variation as they respond to changing supply and demand conditions. This is less likely to be the case with oligopoly pricing, because the incentive not to depart from an established level of high prices may to some extent dampen the responsiveness of prices to costs and demand changes.

3.80 Of particular interest will be evidence of how prices adjust to changes in cost and demand conditions, and any evidence of competition in net prices (after discounts etc) notwithstanding that list prices may move in parallel.

(b) Profitability

3.81 Profitability is the crucial incentive and signal in a market economy and high profits by individual companies at various times are fully consistent with competitive markets. More generally, a competitive market is likely to generate significant variations in profit levels between firms as supply and demand conditions change, but with an overall tendency towards levels commensurate with the cost of capital of the firms involved. At points in time, the profits of some firms may exceed what might be termed the 'normal' level. Reasons for this could include, for instance, cyclical factors, transitory price or other initiatives, the fact that some firms may be more efficient than others and, the fact that some firms may be earning profits gained as a result of past innovation. However, in nearly all cases competition should result in pressure on profit levels towards the cost of capital in the medium to long run.

3.82 However, a situation where, persistently, profits are substantially in excess of the cost of capital for firms that represent a substantial part of the market could be an indication of limitations in the competitive process. For instance, in some cases a high level of profitability could be indicative of significantly coordinated behaviour. Therefore, in the context of a market reference, the Commission will normally consider profit levels, usually in terms of rates of return on capital in the market or markets concerned,[22] as a further indicator of competitive conditions.

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[22] The Commission will normally consider returns on the depreciated replacement cost of assets, unless there are specific reasons why this is inappropriate. Such profits could be significantly different from profits reported in statutory accounts which are usually on a historic cost (or modified historic cost) basis.

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3.83 Low profits, on the other hand, may conceal ineffective competition if firms with market power are able to operate with higher costs than would be sustainable with keener rivalry in the market. Therefore the Commission may also look at data on costs and compare actual costs with efficient costs in addition to looking at profits. This highlights that the Commission will not consider profitability in isolation, but only in the context of its overall assessment.

3.84 Normally in measuring profitability the Commission's approach will be to start with accounting profit produced in line with UK generally accepted accounting practice and then make adjustments. Cost allocation issues will often be significant as frequently the Commission will be investigating a market which does not represent the whole of the firm's business and may not correspond to the corporate or management structure.

3.85 In assessing levels of profitability the Commission will have regard to its view of firms' cost of capital, though it would not normally expect to apply this as a rigid benchmark. The Commission will generally look to the Capital Asset Pricing Model (CAPM) when considering the cost of capital, but will have regard to alternative models where appropriate. Moreover, the Commission recognises the difficulty in measuring the cost of capital and its limited applicability to some industries, such as some markets for services and products with a high intellectual property value. In such situations the Commission may consider alternative measures, such as the return on sales or other relevant financial ratios. For instance, comparisons with businesses operating in different but similar markets may on occasions be helpful, but will be of limited usefulness unless the Commission can confirm the validity of the comparison.

(c) International price comparisons

3.86 International price differences may be an important indicator in deciding to refer a case to the Commission. The scope to use them as a definite indicator of a lack of competition is likely to be much more limited.

3.87 In order to make the comparison meaningful, a number of factors need to be taken into account. At the product level, product names and pack sizes, for example, may differ from one country to another. There can be quality differences between countries for similar products, and difficulties in establishing which products are comparable, notably for retailers' own-label brands. A product may be more popular (and a more important item in consumers' budgets) in one country than another, and its price in that country may benefit from economies of scale. On a broader level, other factors independent of the products themselves need to be taken into account. Prices will tend to reflect potentially very different costs of land, capital, employment etc, in different countries and, where there is limited international trade, such price differentials may persist indefinitely. However, where international trade is relatively easy, the Commission would regard persistently large price differentials as one indicator of less than fully effective competition. International price comparisons reflect the exchange rate used to make the comparison; fluctuations in exchange rates can have a crucial effect on international price comparisons, as well as on trade flows. Different tax regimes can also contribute to differences in prices between countries.

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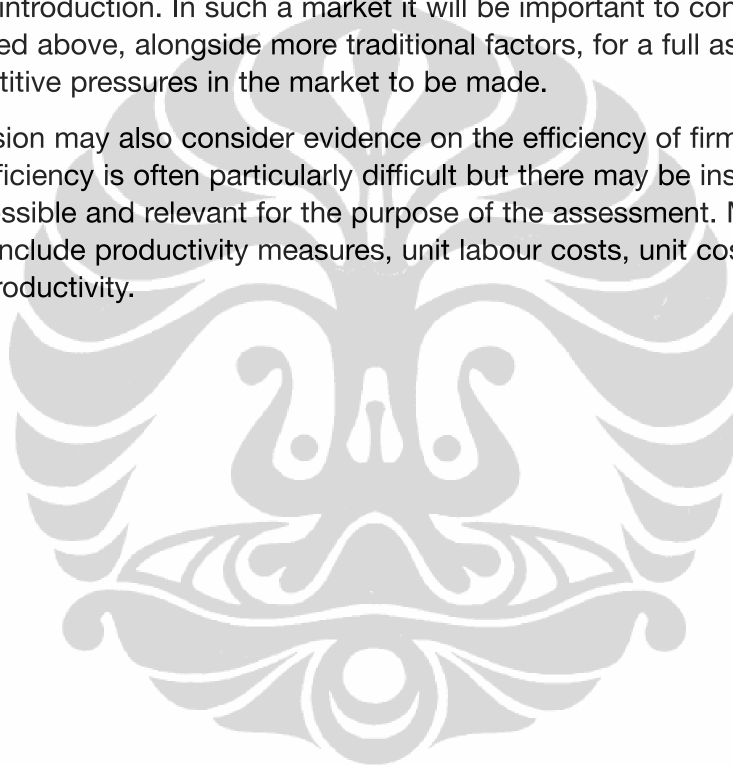
3.88 Although the inherent difficulties in drawing firm conclusions from international price comparisons limit their value, there may be market investigation references where such issues can be allowed for, so that comparisons can provide useful supporting evidence for the Commission's assessment whether structural or conduct features of a market have adverse effects on competition.

(d) Other indicators

3.89 When relevant and feasible, the Commission may also consider other evidence, for instance, customer behaviour, the rate of innovation, product range, and product quality in the relevant market. Comparisons may be made with the performance of the market in the past, internationally, or in other markets with similar characteristics. For instance, focusing solely on prices and profits may give an incomplete picture of the nature of competition in a high technology market, where competition is usually characterised by, amongst other things, new product introduction. In such a market it will be important to consider the factors outlined above, alongside more traditional factors, for a full assessment of the competitive pressures in the market to be made.

3.90 The Commission may also consider evidence on the efficiency of firms. Measuring efficiency is often particularly difficult but there may be instances where it is possible and relevant for the purpose of the assessment. Measures of efficiency include productivity measures, unit labour costs, unit costs and total factor productivity.



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Part 4: Remedial action

Introduction

4.1 This Part considers remedies, starting with the statutory questions the Commission has to answer for each market investigation reference if it has decided that a market feature, or any combination of market features, has an adverse effect on competition. It then describes the various factors that may be relevant to the Commission's decision on the appropriateness of taking remedial action and the action to take, including the effectiveness of different types of remedy, costs and proportionality. It then considers different types of remedy before describing finally how the Commission will take relevant customer benefits into account when deciding on appropriate remedial action.

The remedy questions

4.2 If the Commission has decided on a market investigation reference that a market feature, or any combination of market features, has an adverse effect on competition, it then has to decide whether any action should be taken (or whether it should recommend action be taken by others) in order to remedy the adverse effect on competition and, if so, what action should be taken (see paragraph 1.8).

4.3 Action can be taken by the Commission itself through exercising its order making powers or accepting undertakings from the parties (see paragraphs 4.42 to 4.45). Alternatively, the Commission may recommend that remedial action should be taken by others, such as government, regulators and public authorities, to remedy the adverse effects on competition or any detrimental effect on customers resulting from the adverse effect on competition. Such recommendations could not bind the person to whom they are addressed. They can be additional or alternative to remedial action taken by the Commission. The third question asks the Commission to state the action that should be taken and what it is designed to address.

4.4 The Act requires the Commission, in considering these questions:

in particular to have regard to the need to achieve as comprehensive a solution as is reasonable and practicable to the adverse effect on competition and any detrimental effects on customers so far as resulting from the adverse effect on competition.[23]

4.5 The paragraphs that follow describe various factors that may be relevant to a case and which, if so, will be taken into account when deciding on the appropriateness of taking remedial action and the action to be taken. In practice, these can rarely be considered in isolation from each other and key to the Commission's choice of remedy will be its duty to remedy the adverse effect on competition and any detrimental effects on customers.

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[23] Section 134(6).

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4.6 It is important to note that the remedial action can be directed at the adverse effect of a market feature on competition or the detrimental effects on customers of the adverse effect on competition. In other words, remedial action may deal with the source of the problem or with its consequences. In general, the Commission will seek to implement (or recommend) remedies that address the cause of the problem. It may also choose to address the detrimental effect on customers in addition or as an alternative. However, it is prevented from taking action to address future detrimental effects on customers if no detrimental effects on customers currently exist and the Commission is not remedying the adverse effect on competition (that is, the source of the problem).[24] In practice, the Commission will seek remedies that would both ameliorate the competition problem and mitigate its effects on customers. A remedy that significantly and rapidly increased competitive pressures in a market would normally have these desirable properties.

Remedies

(a) Consideration of appropriate remedies

4.7 Although the Commission must always consider the appropriateness of any remedial action, it is unlikely that the Commission, having decided that there is an adverse effect on competition, will decide that there is no case for remedial action, at least before it has given attention to any relevant customer benefits that may accrue from the market features. Examples of exceptional circumstances where the Commission may conclude that no action is appropriate might be where the costs of any practicable remedy seem disproportionate in the light of the size of the relevant market or where the only appropriate remedial action would fall outside the United Kingdom's jurisdiction. However, even in these circumstances, the Commission, having decided that no action should be taken by it, may recommend action by others; for example, if the matter were of sufficient concern that the OFT or other body with appropriate powers might keep the future conduct of the firms in the market under review.

4.8 The Act also enables the Commission to take into account any relevant customer benefits that arise from one or more features of the market when deciding whether, and if so, what action should be taken. This consideration too may lead to the decision that no action should be taken. The circumstances in which customer benefits can be considered, and what constitutes a relevant customer benefit are explained later in this Part.

4.9 The remedial action that the Commission will decide should be taken will always depend on the facts and circumstances of the case. When deciding what is an appropriate remedy, the Commission will consider the effectiveness of different remedies and their associated costs and will have regard to the principle of proportionality. These are discussed in the next sections.

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[24] Section 138(6).

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(b) The cost of remedies and proportionality

4.10 The Commission must have regard to the reasonableness of any remedy and will aim to ensure that no remedy is disproportionate in relation to the adverse effect on competition and any adverse effects on customers. Part of its consideration will include an assessment of the costs of implementing a remedy, for example in disbanding or modifying a distribution system; and the costs of complying with a remedy, for example, providing the OFT with periodic information on prices or margins. However, the Commission must consider the wider picture. Adverse effects on competition are likely to result in a cost or disadvantage to the UK economy in general and customers in particular. Where significant, these costs might usually be expected to outweigh the costs incurred by any person on whom remedies are imposed. If the Commission is choosing between two remedies which it considers would be equally effective, it will choose the remedy that imposes the least cost or that is least restrictive.

4.11 Other costs such as environmental costs or the social costs of unemployment will not be assessed by the Commission in its consideration of remedies which are intended to address the adverse effects on competition or any detrimental effects on customers.

4.12 The Commission will endeavour to minimise any ongoing compliance costs to the parties, subject to the effectiveness of the remedy not being reduced, and will have regard to the OFT's costs in monitoring compliance, with any remedies that the Commission may put in place.

(c) Effectiveness of remedies

4.13 Before the several types of remedy are considered in more detail, a few general observations can be made about the effectiveness of remedies.

4.14 First, a factor bearing on the effectiveness of any remedy is whether it is clear to the persons to whom it is to be directed and also to other relevant interested parties, for example, the OFT, which has responsibility for monitoring, compliance, and other regulators. Other examples include competitors, suppliers and customers, each of whom may have an interest in ensuring compliance and may bring to the OFT's attention any concern that a remedy is not being complied with. This consideration can be particularly relevant to remedies concerning ongoing behaviour and the Commission will consider whether it is possible to devise a remedy that is both clear and not overly intrusive in its regulation of a firm's behaviour.

4.15 A second consideration is the prospect of the remedial action being implemented and complied with. Some remedies are in effect a commitment as to future behaviour or a standard as to acceptable future behaviour. There may be less certainty with some remedies compared to others that the remedies will have the desired effect. A relevant factor will be the ease of monitoring and enforcing compliance notwithstanding the possibility of setting a compliance programme. The effectiveness of any remedy may be reduced if elaborate, and possibly costly, monitoring and compliance programmes are required. One advantage of one-off remedies that change the structure of the market (so-called structural remedies) when compared with some remedies that impinge upon the behaviour or conduct of firms (so-called behavioural remedies) is that

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they address the competition concern directly and will require comparatively little, if any, monitoring or enforcement of compliance. However, when deciding upon the action to take, and having considered all other relevant factors, this factor alone may not be decisive.

4.16 A third consideration is the timescale within which the effects of any remedial action will occur. Some remedies will have a more or less immediate effect while the effects of others will be delayed. There may be particular uncertainty about the timescale within which results can be expected when the remedy calls for action by some other person, for example a recommendation to government to change regulations. The Commission will tend to favour a remedy that can be expected to show results in a relatively short time period – so long as it is satisfied that the remedy is both reasonable and practicable and has no adverse long-run consequences.

4.17 In their consideration, the Commission must have regard to the relevant statatory functions of the sector regulator concerned.[25]

(d) Types of remedy

4.18 Except for the statutory limits on the content of orders, there are no formal restrictions on the remedial action that the Commission can take or recommend. However, possible remedies can be categorised as follows:

(a) remedies designed to make a significant and direct change to the structure of a market by a requirement, for example, to divest a business or assets to a newcomer to the market or to an existing, perhaps smaller, competitor;

(b) remedies designed to change the structure of a market less directly by reducing entry barriers or switching costs, for example, by requiring the licensing of know-how or intellectual property rights or by extending the compatibility of products through industry-wide technical standards;

(c) as a particular category of (b), recommendations for changes to regulations found to have adverse effects on competition or detrimental effects on customers, for example, by limiting entry to a market;

(d) remedies directing firms (whether sellers or buyers) to discontinue certain behaviour (for example, giving advance notice of price changes) or to adopt certain behaviour (for example, more prominently displaying prices and other terms and conditions of sale)

(e) remedies designed to restrain the way in which firms would otherwise behave, for example, the imposition of a price cap;

(f) monitoring remedies, for example, a requirement to provide the OFT with information on prices or profits.

4.19 Most of the examples above are remedies that would fall to the Commission itself to impose. Examples of remedies that would require action by other persons or bodies such as government, regulators and other public bodies include changes to regulations and measures to increase market transparency.

[25] Section 168.

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4.20 The Commission will also consider whether to recommend that action be taken by others. This could be action aimed at encouraging increased competition in the market(s) affected. For example, it might recommend action by government to change legislation or regulations that limit or control entry. Alternatively action could aim to prevent or limit potentially anti-competitive behaviour.

4.21 It will, of course, be for the government or other person to whom action is recommended to decide whether to act. However, the government has given a commitment to consider any Commission recommendation and to give a public response within 90 days of publication of the Commission's report.[26] The response may set out the changes it proposes to make in the light of the report or options on which it proposes to consult. Inevitably, as it falls to others to make a decision on the recommendation, there will be uncertainty over whether the recommendation will be accepted and, if so, over the time period before which it will be implemented. It will be necessary to take this inherent uncertainty into account when deciding whether to make such a recommendation.

(e) Choice of remedy

4.22 In deciding what remedy or remedies would be appropriate, the Commission will first look for a remedy that would be effective in dealing with the adverse effects on competition of the market features rather than seeking to deal with any detrimental effects on customers. Clearly, what type of effective action to increase competition can be taken will depend on the nature of the feature or features concerned. For example, if the feature was a widespread practice of recommending resale prices in a market with plenty of suppliers, it is likely that competition would be stimulated, either between those suppliers or between their (retail) customers, or between both, by a remedy that prohibited the practice.

4.23 In looking for remedies that would be likely to increase competition in the relevant market(s), the Commission will give attention to the time period within which the remedy can be expected to show results. If the remedy is not likely to have speedy results, the Commission may choose an alternative remedy or implement additional remedies such as those to remedy the detrimental effects on customers during the interim period. Otherwise, not only might there be uncertainty as to whether the effects would ever materialise, but in the meantime customers would continue to suffer from the consequences of the adverse effects on competition.

4.24 Remedies that increase the effectiveness of competition may include behavioural as well as structural remedies. Where, in particular, the conduct of firms has given rise to adverse and detrimental effects, it can be expected that the Commission will consider behavioural remedies. These can take many forms but can have a number of shortcomings. They can involve detailed prescription of rules of conduct, for example relating to the terms of trade with customers and suppliers, though there may, in some cases, be a danger of restraining legitimate competitive behaviour and otherwise being overly intrusive. They can require detailed monitoring by the OFT or the sector regulator. Notwithstanding the ability to vary any remedy imposed, behavioural remedies can be difficult to

[26] A World Class Competition Regime July 2001 DTI paragraph 4.15.

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keep in tune with developing market conditions and might introduce their own distortions of competition. Nevertheless, behavioural remedies of one kind or another are a likely outcome of some market investigations.

4.25 Remedial action may also be required to address the adverse effects on competition directly, for example where remedies aimed at correcting the features which have caused those effects will not bear fruit for some time. Price restraints are the most obvious example, though there may be others. However, they are not likely, by their nature, to provide a solution to the underlying problem, that is, the market features that adversely affect the process of competition, and on that account are less preferable.

Customer benefits

(a) Relevant customer benefits

4.26 The Commission may in deciding the question of remedies:[27]

in particular, have regard to the effect of any action on any relevant customer benefits of the feature or features of the market concerned.

4.27 It would not normally be expected that market features that adversely affect competition could have beneficial rather than detrimental effects on customers. The usual consequence of a failure of competition is that prices will be higher not lower than they would be with more competition. Nevertheless, the alternative possibility is recognised in the legislation.

4.28 The Commission will disregard any benefits that might arise from commitments that the parties may wish to offer but that do not meet the criteria of a relevant customer benefit. That is, the benefits must clearly result from one or more features and be unlikely to have come about without the feature or features concerned.

4.29 Relevant customer benefits are limited to benefits to relevant customers in the form of:[28]

(a) lower prices, higher quality or greater choice of goods or services in any market in the United Kingdom (whether or not the market to which the feature or features concerned relate); or

(b) greater innovation in relation to such goods or services.

4.30 The Act provides that a benefit is only a relevant customer benefit if the Commission believes that:

(a) the benefit has accrued as a result (whether wholly or partly) of the feature or features concerned or may be expected to accrue within a reasonable period of time as a result (whether wholly or partly) of that feature or those features; and

(b) the benefit was, or is, unlikely to accrue without the feature or features concerned.[29]

4.31 In considering potential relevant customer benefits, the Commission will need to ascertain that market features with which it has been concerned do indeed lead to lower prices, higher quality, wider choice or greater innovation, and that

[27] Section 134(7).
[28] Section 134(8).
[29] Section 134(8).

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they are both attributable to the market features and not attainable in any other way. The Commission will tend to disregard benefits that are purely speculative, or would only arise at some time in the distant future.

(b) Possible relevant customer benefits

4.32 It is not possible to give detailed guidance on particular benefits that may be relevant customer benefits in market investigations, as this will tend to reflect the characteristics of a particular market. However, in the following paragraphs, examples of possible relevant customer benefits are given. In all instances the Commission will need to consider whether the criteria set out in paragraph 4.30 above are met.

4.33 Features of a market structure that could adversely affect competition, such as a high level of concentration, might enable economies of scale to be obtained that would not be available if there were a larger number of firms in the market. Scale economies would only be a customer benefit if they meant that prices would be lower than if there were more firms competing in the market. Whether scale economies could be a relevant customer benefit would therefore depend on whether there was sufficient pressure on the firms in the market, perhaps as a result of potential competition from new entrants, or countervailing buyer power, for any cost economies to be substantially passed on as lower prices.

4.34 Another potential benefit from high concentration is innovation. The riskiness and cost of R&D in many industries is such that in many instances it will only be undertaken by firms of some size and with a degree of market power. Prices may be higher than they would be with a more competitive market structure but the pace with which commercially successful new products or methods are introduced may well be faster. Again some continuing competitive threat is likely to be necessary if the incentive to innovate is to be maintained.

4.35 Customers are unlikely to enjoy any relevant benefits as a direct result of entry barriers, although some entry barriers may secure other kinds of benefit, for example regulations that limit entry to persons of proven competence or with adequate capital resources. The Commission will have regard to the wider purpose of such regulations in determining whether they have an adverse effect on competition. Generally, customers might be expected to benefit from any reduction of entry barriers.

4.36 Vertical integration and vertical agreements can have beneficial effects through the better coordination of activities at different stages of the supply chain and savings in transaction and inventory costs. With vertical integration, this is achieved by internalising activities which would otherwise be carried out in separately owned businesses. With vertical agreements it is achieved by a closer alignment of the incentives of, say the supplier and his distributor, towards the achievement of complementary objectives. Vertical restrictions within the supply chain may also help to resolve the free rider problem[30] in markets where suppliers need their distributors to incur certain necessary costs if advice and other pre-sale services are to be provided on a sustained basis.

4.37 Where vertical integration or vertical agreements enable a firm in a competitive market to increase its business at the expense of its rivals, the vertical arrangement is likely to be beneficial. It is where one of the firms concerned

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[30] Free rider problems exist where other parties benefit from the provision of a good or service without paying for its provision.

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has market power, or where vertical arrangements are widespread in a market, that the foreclosure effects and a possible increase in entry barriers, leading to a dampening of competitive pressures, can outweigh any efficiency benefits.

4.38 Many forms of business conduct can similarly have ambiguous effects. Tie-in sales or product bundling, for example, can be convenient to customers, reduce transaction costs and provide quality assurance. When practised by firms with market power or when the conduct is widespread in a market, however, these practices can adversely affect the competitive process by disadvantaging competitors supplying only one of the tied or bundled products.

(c) Relevant customer benefits and remedies

4.39 If the Commission is satisfied that there are relevant customer benefits deriving from a market feature that also has adverse effects on competition, the Commission will consider whether to modify the remedy that it might otherwise have imposed or recommended. When deciding whether to modify a remedy, the Commission will consider a number of factors including the size and nature of the expected benefit and how long the benefit is to be sustained. The Commission will also consider the different impacts of the features on different customers. It is possible that the benefits are of such significance compared with the effects of the market feature(s) on competition that the Commission will decide that no remedy is called for. Given, however, that the Commission will have found adverse effects on competition this is not likely to occur frequently.

4.40 Alternatively, the Commission, as a result of identifying relevant customer benefits, may choose a different remedy, for example a behavioural remedy rather than a structural remedy. In this situation, the Commission will have to weigh the disadvantage of a less effective remedy to the competition problem against the benefits that result from the feature concerned.

4.41 The Commission may also consider whether to impose a monitoring remedy to give some assurance that the expected benefits would be forthcoming. Monitoring alone does nothing to deal with the competition issues raised by a market investigation. But it may enable the competition authorities and regulators to decide whether any further action is called for.

Undertakings and orders

4.42 As far as its own actions are concerned, the Commission will have the choice of seeking undertakings from the persons that are to be the subject of the measures or making of an order. In general, the Commission's decision as to which form to use will be determined by issues of practicality such as the numbers of parties concerned, and their willingness to negotiate and agree undertakings in the light of the Commission's report. Another consideration will be the scope of the Commission's powers and whether the remedy that it considers appropriate falls within those powers.

4.43 The Commission's order making powers are set out in the Act. Schedule 8 sets out the types of provisions that could be included in an order and Part 1 of Schedule 9 enables the Commission to modify, by order, licence conditions in various regulated markets. While the content of any orders made by the

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Commission is limited by the Act, the subject matter of an undertaking is not similarly limited.[31] The process of negotiation that is involved with undertakings and the fact that their content is not limited to the matters contained in Schedule 8 may be advantageous in terms of flexibility and suitability.

4.44 The essence of market investigations is that they are likely to be market-wide rather than focused on the conduct of one firm, and a remedy may be more effective if imposed by order than sought through undertakings. For example, because of the need to negotiate undertakings it may take longer to implement a remedy if undertakings are used instead of an order, particularly if many parties are involved. This can complicate the process of negotiation of effective undertakings. When the particular circumstances of the case point to the need for action to be taken speedily, the Commission may decide to implement the remedy by way of order to avoid delay while undertakings are negotiated. But any generalisation has to be qualified: which is the better approach must depend upon the facts of the particular case. However, in regulated sectors, if the Commission decides to modify licence conditions in connection with Part 1 of Schedule 9 to give effect to or take account of any provision of a proposed remedy, it will make an order.

(a) Procedural and other aspects of undertakings and orders

4.45 For more information about undertakings and orders, and the procedures that will apply when remedies are being considered, see *General Advice and Information* Part 6 and 7.

[31] Section 164(1).

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Part 5: Public interest cases

5.1 If the Secretary of State believes that one or more public interest considerations is relevant to a market investigation she may intervene by serving an intervention notice under section 139 of the Act. The notice may be given up to four months from the date of the reference provided the reference is not finally determined.[32] Intervention by the Secretary of State is likely to occur only exceptionally. The interests of national security is a public interest consideration but the Secretary of State may, by order, specify new public interest considerations.[33]

5.2 In public interest cases, the Commission will have to decide the first of the questions that apply to all other market investigation references, namely, whether any feature, or combination of features, of each relevant market prevents, restricts or distorts competition in connection with the supply or acquisition of any goods or services in the United Kingdom or a part of the United Kingdom. The considerations explained in Parts 2 and 3 will be relevant to the Commission's consideration of this question.

5.3 If the Commission has decided that there is an adverse effect on competition, it must decide a number of questions concerning the taking of remedial action. There are two different sets of questions which are set out in paras 5.4 and 5.5. The first set of questions relates to the action the Secretary of State might take. The second set relates to the action the Commission might take in the event that the case reverts back to the Commission. The case will revert to the Commission if the Secretary of State fails within 90 days of receipt of the Commission's report to make and publish her decision as to whether any eligible public interest considerations are relevant to any action mentioned in the Commission's report in its decision on the second type of question or if the Secretary of State decides that no eligible public interest consideration is relevant to any such action. An eligible public interest consideration is one which was mentioned in the intervention notice given by the Secretary of State and which the Commission is not required to disregard.[34] Whether the action identified in response to those questions is the action to be taken will ultimately depend upon the decision of the Secretary of State and whether the case reverts to the Commission under section 148 of the Act.[35]

5.4 The first set of questions is:[36]

(a) *whether action should be taken by the Secretary of State under section 147 for the purpose of remedying, mitigating or preventing the adverse effect on competition concerned or any detrimental effect on customers so far as it has resulted from, or may be expected to result from, the adverse effect on competition;*

(b) *whether the Commission should recommend the taking of other action by the Secretary of State or action by persons other than itself and the Secretary of State for the purpose of remedying, mitigating or preventing the effect on competition concerned or any detrimental effect on customers so far as it has resulted from, or may be expected to result from, the adverse effect on competition; and*

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[32] The circumstances in which a case is finally determined are set out in section 140(5) and include when the period for the Commission to prepare its report and for action to be taken has expired.
[33] The public interest considerations are specified in section 153 of the Act. The Secretary of State may by order specify other considerations and may remove or amend any specified considerations.
[34] Section 145(3) and (4) provide that the Commission must disregard a public interest consideration which has not been finalised before the giving of its report and must disregard a public interest consideration which was not finalised on the giving of the intervention notice and has not been finalised within the period of 24 weeks beginning with the giving of the notice concerned.
[35] See Part 4 of *General Advice and Information*

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(c) *in either case, if action should be taken, what action should be taken and what it is to be remedied, mitigated or prevented.*

5.5 The second set of questions is:[37]

(a) *whether action should be taken by [the Commission] for the purpose of remedying, mitigating or preventing the adverse effect on competition concerned or any detrimental effect on customers so far as it has resulted from, or may be expected to result from, the adverse effect on competition;*

(b) *whether the Commission should recommend the taking of action by other persons for the purpose of remedying, mitigating or preventing the adverse effect on competition concerned or any detrimental effect on customers so far as it has resulted from, or may be expected to result from, the adverse effect on competition; and*

(c) *in either case, if action should be taken, what action should be taken and what is to be remedied, mitigated or prevented.*

5.6 In deciding both sets of questions the Commission must, as is the case in general market investigation references (in which public interest considerations do not arise), have particular regard to the need to achieve as comprehensive a solution as is reasonable and practicable to the adverse effect on competition concerned and any detrimental effects on customers so far as resulting from the adverse effect on competition. Similarly, the Commission may have regard to the effect of any action on any relevant customer benefits of the feature or features of the market concerned. In respect of both sets of questions, the factors mentioned in Part 4 will be relevant to the Commission's consideration when deciding these questions. In addition, when deciding the first set of questions, the Commission will have regard to the matters mentioned in paragraphs 5.7 to 5.9.

5.7 When answering the questions set out in paragraph 5.4, the Commission will have regard to section 147 of the Act which applies if the Secretary of State has decided that one or more eligible public interest consideration is relevant and has published her decision within the period of 90 days beginning with the receipt of the report from the Commission. In particular, this gives the Secretary of State the power in relation to any adverse effect on competition identified in the Commission's report to take such action as she considers to be:[38]

(a) *reasonable and practicable –*

(i) *to remedy, mitigate or prevent the adverse effect on competition concerned; or*

(ii) *to remedy, mitigate or prevent any detrimental effect on customers so far as it has resulted from, or may be expected to result from, the adverse effect on competition; and*

(b) *appropriate in the light of the eligible public interest consideration concerned or (as the case may be) the eligible public interest considerations concerned.*

[36] Section 141(3).
[37] Section 141(4).
[38] Section 147(2).

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5.8 The Secretary of State is required to have regard to:[39]

(a) the need to achieve as comprehensive a solution as is reasonable and practicable to the adverse effect on competition concerned and any detrimental effects on customers so far as resulting from the adverse effect on competition; and

(b) the report of the Commission.

5.9 The Secretary of State may have regard to the effect of any action on any relevant customer benefits of the feature or features of the market concerned. The Secretary of State is prevented from taking action to address future detrimental effects on customers if no detrimental effects on customers currently exist and the adverse effect on competition is not being remedied.

5.10 If the case reverts to the Commission, the Commission must obtain the Secretary of State's agreement if it proposes to depart materially from the course of action set out in its report. However, the Secretary of State may only withhold her agreement if she believes that the Commission's new proposed course of action would operate against the public interest. The alternative course of action would so operate if any eligible public interest considerations outweigh the considerations that have led the Commission to propose the alternative action. In making her decision, the Secretary of State must accept the Commission's view of what would be the most appropriate action to take to remedy the adverse effect on competition and any resulting detrimental effects on customers.[40]

5.11 Further information about public interest cases may be found in *General Advice and Information*, Part 3.

[39] Section 147(3).
[40] Section 148.

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Annex

Information relevant to the Enterprise Act

Competition Commission publications

www.competition-commission.org.uk

CC1 Competition Commission: Rules of Procedure

CC2 Merger References: Competition Commission Guidelines

CC3 Market Investigation References: Competition Commission Guidelines

CC4 General Advice and Information

CC5 Statement of Policy on Penalties

CC6 Chairman's Guidance to Groups

CC7 Chairman's Guidance on Disclosure of Information in Merger and Market Inquiries

Competition Commission Annual review and accounts

OFT publications

www.oft.gov.uk

OFT 508 Overview of the Enterprise Act

OFT 506 Mergers: Substantive Assessment

OFT 526 Mergers: procedural guidance

OFT 501 Market Investigation References

Competition Appeal Tribunal publications

Competition Appeal Tribunal Rules *www.catribunal.org.uk*

Department of Trade and Industry information

See DTI website *www.dti.gov.uk/ccp*

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Commission guidelines on market analysis and the assessment of significant market power under the Community regulatory framework for electronic communications networks and services

(2002/C 165/03)

(Text with EEA relevance)

1. INTRODUCTION

1.1. Scope and purpose of the guidelines

1. These guidelines set out the principles for use by national regulatory authorities (NRAs) in the analysis of markets and effective competition under the new regulatory framework for electronic communications networks and services.

2. This new regulatory framework comprises five Directives: Directive 2002/21/EC of the European Parliament and of the Council of 7 March 2002 on a common regulatory framework for electronic communications networks and services [1], hereinafter the framework Directive; Directive 2002/20/EC of the European Parliament and of the Council of 7 March 2002 on the authorisation of electronic communications networks and services [2], hereinafter the authorisation Directive; Directive 2002/19/EC of the European Parliament and of the Council of 7 March 2002 on access to, and interconnection of, electronic communications networks and associated facilities [3], hereinafter the access Directive; Directive 2002/22/EC of the European Parliament and of the Council of 7 March 2002 on universal service and users' rights relating to electronic communications networks and services [4], hereinafter the universal service Directive; a Directive of the European Parliament and of the Council concerning the processing of personal data and the protection of privacy in the electronic communications sector [5]. However, until this last Directive is formally adopted, Directive 97/66/EC of the European Parliament and the Council concerning the processing of personal data and protection of privacy in the telecommunications sector [6], hereinafter the data protection Directive, remains the relevant Directive.

3. Under the 1998 regulatory framework, the market areas of the telecommunications sector that were subject to *ex-ante* regulation were laid down in the relevant directives, but were not markets defined in accordance with the principles of competition law. In these areas defined under the 1998 regulatory framework, NRAs had the power to designate undertakings as having significant market power when they possessed 25 % market share, with the possibility to deviate from this threshold taking into account the undertaking's ability to influence the market, its turnover relative to the size of the market, its control of the means of access to end-users, its access to financial resources and its experience in providing products and services in the market.

4. Under the new regulatory framework, the markets to be regulated are defined in accordance with the principles of European competition law. They are identified by the Commission in its recommendation on relevant product and service markets pursuant to Article 15(1) of the framework Directive (hereinafter 'the Recommendation'). When justified by national circumstances, other markets can also be identified by the NRAs, in accordance with the procedures set out in Articles 6 and 7 of the framework Directive. In case of transnational markets which are susceptible to *ex-ante* regulation, they will where appropriate be identified by the Commission in a decision on relevant transnational markets pursuant to Article 15(4) of the framework Directive (hereinafter 'the Decision on transnational markets').

5. On all of these markets, NRAs will intervene to impose obligations on undertakings only where the markets are considered not to be effectively competitive [7] as a result of such undertakings being in a position equivalent to dominance within the meaning of Article 82 of the EC Treaty [8]. The notion of dominance has been defined in the case-law of the Court of Justice as a position of economic strength affording an undertaking the power to behave to an appreciable extent independently of competitors, customers and ultimately consumers. Therefore, under the new regulatory framework, in contrast with the 1998 framework, the Commission and the NRAs will rely on competition law principles and methodologies to define the markets to be regulated *ex-ante* and to assess whether undertakings have significant market power ('SMP') on those markets.

6. These guidelines are intended to guide NRAs in the exercise of their new responsibilities for defining markets and assessing SMP. They have been adopted by the Commission in accordance with Article 15(2) of the framework Directive, after consultation of the relevant national authorities and following a public consultation, the results of which have been duly taken into account.

7. Under Article 15(3) of the framework Directive, NRAs should take the utmost account of these guidelines. This will be an important factor in any assessment by the Commission of the proportionality and legality of proposed decisions by NRAs, taking into account the policy objectives laid down in Article 8 of the framework Directive.

8. These guidelines specifically address the following subjects: (a) market definition; (b) assessment of SMP; (c) SMP designation; and (d) procedural issues related to all of these subjects.

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9. The guidelines have been designed for NRAs to use as follows:

— to define the geographical dimension of those product and service markets identified in the Recommendation. NRAs will not define the geographic scope of any transnational markets, as any Decision on transnational markets will define their geographic dimension,

— to carry out, using the methodology set out in Section 3 of the guidelines, a market analysis of the conditions of competition prevailing in the markets identified in the Recommendation and Decision and by NRAs,

— to identify relevant national or sub-national product and service markets which are not listed in the Recommendation when this is justified by national circumstances and following the procedures set out in Articles 6 and 7 of the framework Directive,

— to designate, following the market analysis, undertakings with SMP in the relevant market and to impose proportionate *ex-ante* measures consistent with the terms of the regulatory framework as described in Sections 3 and 4 of the guidelines,

— to assist Member States and NRAs in applying Article 11(1f) of the authorisation Directive, and Article 5(1) of the framework Directive, and thus ensure that undertakings comply with the obligation to provide information necessary for NRAs to determine relevant markets and assess significant market power thereon,

— to guide NRAs when dealing with confidential information, which is likely to be provided by:

  — undertakings under Article 11(1f) of the authorisation Directive and Article 5(1) of the framework Directive,

  — national competition authorities (NCAs) as part of the cooperation foreseen in Article 3(5) of the framework Directive, and

  — the Commission and a NRA in another Member State as part of the cooperation foreseen in Article 5(2) of the framework Directive.

10. The guidelines are structured in the following way:

Section 1 provides an introduction and overview of the background, purpose, scope and content of the guidelines. **Section 2** describes the methodology to be used by NRAs to define the geographic scope of the markets identified in the market Recommendation as well as to define relevant markets outside this Recommendation. **Section 3** describes the criteria for assessing SMP in a relevant market. **Section 4** outlines the possible conclusions that NRAs may reach in their market analyses and describes the possible actions that may result. **Section 5** describes the powers of investigation of NRAs, suggests procedures for coordination between NRAs and between NRAs and NCAs, and describes coordination and cooperation procedures between NRAs and the Commission. Finally, **Section 6** describes procedures for public consultation and publication of NRAs' proposed decisions.

11. The major objective of these guidelines is to ensure that NRAs use a consistent approach in applying the new regulatory framework, and especially when designating undertakings with SMP in application of the provisions of the regulatory framework.

12. By issuing these guidelines, the Commission also intends to explain to interested parties and undertakings operating in the electronic communications sector how NRAs should undertake their assessments of SMP under the framework Directive, thereby maximising the transparency and legal certainty of the application of the sector specific legislation.

13. The Commission will amend these guidelines, whenever appropriate, taking into account experience with the application of the regulatory framework and future developments in the jurisprudence of the Court of First Instance and the European Court of Justice.

14. These guidelines do not in any way restrict the rights conferred by Community law on individuals or undertakings. They are entirely without prejudice to the application of Community law, and in particular of the competition rules, by the Commission and the relevant national authorities, and to its interpretation by the European Court of Justice and the Court of First Instance. These guidelines do not prejudice any action the Commission may take or any guidelines the Commission may issue in the future with regard to the application of European competition law.

1.2. Principles and policy objectives behind sector specific measures

15. NRAs must seek to achieve the policy objectives identified in Article 8(2), (3) and (4) of the framework Directive. These fall into three categories:

— promotion of an open and competitive market for electronic communications networks, services and associated facilities,

— development of the internal market, and

— promotion of the interests of European citizens.

16. The purpose of imposing *ex-ante* obligations on undertakings designated as having SMP is to ensure that undertakings cannot use their market power either to restrict or distort competition on the relevant market, or to leverage such market power onto adjacent markets.

17. These regulatory obligations should only be imposed on those electronic communications markets whose characteristics may be such as to justify sector-specific regulation and in which the relevant NRA has determined that one or more operators have SMP.

18. The product and service markets whose characteristics may be such as to justify sector-specific regulation are identified by the Commission in its Recommendation and, when the definition of different relevant markets is justified by national circumstances, by the NRAs following the procedures set out in Articles 6 and 7 of the framework Directive [9]. In addition, certain other markets are specifically identified in Article 6 of the access Directive and Articles 18 and 19 of the universal service Directive.

19. In respect of each of these relevant markets, NRAs will assess whether the competition is effective. A finding that effective competition exists on a relevant market is equivalent to a finding that no operator enjoys a single or joint dominant position on that market. Therefore, for the purposes of applying the new regulatory framework, effective competition means that there is no undertaking in the relevant market which holds alone or together with other undertakings a single or collective dominant position. When NRAs conclude that a relevant market is not effectively competitive, they will designate undertakings with SMP on that market, and will either impose appropriate specific obligations, or maintain or amend such obligations where they already exist, in accordance with Article 16(4) of the framework Directive.

20. In carrying out the market analysis under the terms of Article 16 of the framework Directive, NRAs will conduct a forward looking, structural evaluation of the relevant market, based on existing market conditions. NRAs should determine whether the market is prospectively competitive, and thus whether any lack of effective competition is durable [10], by taking into account expected or foreseeable market developments over the course of a reasonable period. The actual period used should reflect the specific characteristics of the market and the expected timing for the next review of the relevant market by the NRA. NRAs should take past data into account in their analysis when such data are relevant to the developments in that market in the foreseeable future.

21. If NRAs designate undertakings as having SMP, they must impose on them one or more regulatory obligations, in accordance with the relevant Directives and taking into account the principle of proportionality. Exceptionally, NRAs may impose obligations for access and interconnection that go beyond those specified in the access Directive, provided this is done with the prior agreement of the Commission, as provided by Article 8(3) of that Directive.

22. In the exercise of their regulatory tasks under Article 15 and 16 of the framework Directive, NRAs enjoy discretionary powers which reflect the complexity of all the relevant factors that must be assessed (economic, factual and legal) when identifying the relevant market and determining the existence of undertakings with SMP. These discretionary powers remain subject, however, to the procedures provided for in Article 6 and 7 of the framework Directive.

23. Regulatory decisions adopted by NRAs pursuant to the Directives will have an impact on the development of the internal market. In order to prevent any adverse effects on the functioning of the internal market, NRAs must ensure that they implement the provisions to which these guidelines apply in a consistent manner. Such consistency can only be achieved by close coordination and cooperation with other NRAs, with NCAs and with the Commission, as provided in the framework Directive and as recommended in Section 5.3 of these guidelines.

1.3. Relationship with competition law

24. Under the regulatory framework, markets will be defined and SMP will be assessed using the same methodologies as under competition law. Therefore the definition of the geographic scope of markets identified in the Recommendation, the definition where necessary of relevant product/services markets outside the Recommendation, and the assessment of effective competition by NRAs should be consistent with competition case-law and practice. To ensure such consistency, these guidelines are based on (1) existing case-law of the Court of First Instance and the European Court of Justice concerning market definition and the notion of dominant position within the meaning of Article 82 of the EC Treaty and Article 2 of the merger control Regulation [11]; (2) the 'Guidelines on the application of EEC competition rules in the telecommunications sector' [12]; (3) the 'Commission notice on the definition of relevant markets for the purposes of Community competition law' [13], hereinafter the 'Notice on market definition'; and (4) the 'Notice on the application of competition rules to access agreements in the telecommunications sector' [14], hereinafter the 'Access notice'.

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25. The use of the same methodologies ensures that the relevant market defined for the purpose of sector-specific regulation will in most cases correspond to the market definitions that would apply under competition law. In some cases, and for the reasons set out in Section 2 of these guidelines, markets defined by the Commission and competition authorities in competition cases may differ from those identified in the Recommendation and Decision, and/or from markets defined by NRAs under Article 15(3) of the framework Directive. Article 15(1) of the framework Directive makes clear that the markets to be defined by NRAs for the purpose of *ex-ante* regulation are without prejudice to those defined by NCAs and by the Commission in the exercise of their respective powers under competition law in specific cases.

26. For the purposes of the application of Community competition law, the Commission's Notice on market definition explains that the concept of the relevant market is closely linked to the objectives pursued under Community policies. Markets defined under Articles 81 and 82 EC Treaty are generally defined on an ex-post basis. In these cases, the analysis will consider events that have already taken place in the market and will not be influenced by possible future developments. Conversely, under the merger control provisions of EC competition law, markets are generally defined on a forward-looking basis.

27. On the other hand, relevant markets defined for the purposes of sector-specific regulation will always be assessed on a forward looking basis, as the NRA will include in its assessment an appreciation of the future development of the market. However, NRAs' market analyses should not ignore, where relevant, past evidence when assessing the future prospects of the relevant market (see also Section 2, below). The starting point for carrying out a market analysis for the purpose of Article 15 of the framework Directive is not the existence of an agreement or concerted practice within the scope of Article 81 EC Treaty, nor a concentration within the scope of the Merger Regulation, nor an alleged abuse of dominance within the scope of Article 82 EC Treaty, but is based on an overall forward-looking assessment of the structure and the functioning of the market under examination. Although NRAs and competition authorities, when examining the same issues in the same circumstances and with the same objectives, should in principle reach the same conclusions, it cannot be excluded that, given the differences outlined above, and in particular the broader focus of the NRAs' assessment, markets defined for the purposes of competition law and markets defined for the purpose of sector-specific regulation may not always be identical.

28. Although merger analysis is also applied *ex ante*, it is not carried out periodically as is the case with the analysis of the NRAs under the new regulatory framework. A competition authority does not, in principle, have the opportunity to conduct a periodic review of its decision in the light of market developments, whereas NRAs are bound to review their decisions periodically under Article 16(1) of the framework Directive. This factor can influence the scope and breadth of the market analysis and the competitive assessment carried out by NRAs, and for this reason, market definitions under the new regulatory framework, even in similar areas, may in some cases, be different from those markets defined by competition authorities.

29. It is considered that markets which are not identified in the Recommendation will not warrant *ex-ante* sector specific regulation, except where the NRA is able to justify such regulation of an additional or different relevant market in accordance with the procedure in Article 7 of the framework Directive.

30. The designation of an undertaking as having SMP in a market identified for the purpose of *ex-ante* regulation does not automatically imply that this undertaking is also dominant for the purpose of Article 82 EC Treaty or similar national provisions. Moreover, the SMP designation has no bearing on whether that undertaking has committed an abuse of a dominant position within the meaning of Article 82 of the EC Treaty or national competition laws. It merely implies that, from a structural perspective, and in the short to medium term, the operator has and will have, on the relevant market identified, sufficient market power to behave to an appreciable extent independently of competitors, customers, and ultimately consumers, and this, solely for purposes of Article 14 of the framework Directive.

31. In practice, it cannot be excluded that parallel procedures under *ex-ante* regulation and competition law may arise with respect to different kinds of problems in relevant markets ([15]). Competition authorities may therefore carry out their own market analysis and impose appropriate competition law remedies alongside any sector specific measures applied by NRAs. However, it must be noted that such simultaneous application of remedies by different regulators would address different problems in such markets. *Ex-ante* obligations imposed by NRAs on undertakings with SMP aim to fulfil the specific objectives set out in the relevant directives, whereas competition law remedies aim to sanction agreements or abusive behaviour which restrict or distort competition in the relevant market.

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32. As far as emerging markets are concerned, recital 27 of the framework Directive notes that emerging markets, where *de facto* the market leader is likely to have a substantial market share, should not be subject to inappropriate *ex-ante* regulation. This is because premature imposition of *ex-ante* regulation may unduly influence the competitive conditions taking shape within a new and emerging market. At the same time, foreclosure of such emerging markets by the leading undertaking should be prevented. Without prejudice to the appropriateness of intervention by the competition authorities in individual cases, NRAs should ensure that they can fully justify any form of early, *ex-ante* intervention in an emerging market, in particular since they retain the ability to intervene at a later stage, in the context of the periodic re-assessment of the relevant markets.

2. MARKET DEFINITION

2.1. Introduction

33. In the Competition guidelines issued in 1991 [16], the Commission recognised the difficulties inherent in defining the relevant market in an area of rapid technological change, such as the telecommunications sector. Whilst this statement still holds true today as far as the electronic communications sector is concerned, the Commission since the publication of those guidelines has gained considerable experience in applying the competition rules in a dynamic sector shaped by constant technological changes and innovation, as a result of its role in managing the transition from monopoly to competition in this sector. It should however be recalled that the present guidelines do not purport to explain how the competition rules apply, generally, in the electronic communications sector, but focus only on issues related to (i) market definition; and (ii) the assessment of significant market power within the meaning of Article 14 of the framework Directive (hereafter SMP).

34. In assessing whether an undertaking has SMP, that is whether it 'enjoys a position of economic strength affording it the power to behave to an appreciable extent independently of its competitors, customers and ultimately consumers' [17], the definition of the relevant market is of fundamental importance since effective competition can only be assessed by reference to the market thus defined [18]. The use of the term 'relevant market' implies the description of the products or services that make up the market and the assessment of the geographical scope of that market (the terms 'products' and 'services' are used interchangeably throughout this text). In that regard, it should be recalled that relevant markets defined under the 1998 regulatory framework were distinct from those identified for competition-law purposes, since they were based on certain specific aspects of end-to-end communications rather than on the demand and supply criteria used in a competition law analysis [19].

35. Market definition is not a mechanical or abstract process but requires an analysis of any available evidence of past market behaviour and an overall understanding of the mechanics of a given sector. In particular, a dynamic rather than a static approach is required when carrying out a prospective, or forward-looking, market analysis [20]. In this respect, any experience gained by NRAs, NCAs and the Commission through the application of competition rules to the telecommunication sector clearly will be of particular relevance in applying Article 15 of the framework Directive. Thus, any information gathered, any findings made and any studies or reports commissioned or relied upon by NRAs (or NCAs) in the exercise of their tasks, in relation to the conditions of competition in the telecommunications markets (provided of course that market conditions have since remained unchanged), should serve as a starting point for the purposes of applying Article 15 of the framework Directive and carrying out a prospective market analysis [21].

36. The main product and service markets whose characteristics may be such as to justify the imposition of *ex-ante* regulatory obligations are identified in the Recommendation which the Commission is required to adopt pursuant to Article 15(1) of the framework Directive, as well as any Decision on transnational markets which the Commission decides to adopt pursuant to Article 15(4) of the framework Directive. Therefore, in practice the task of NRAs will normally be to define the geographical scope of the relevant market, although NRAs have the possibility under Article 15(3) of the framework Directive to define markets other than those listed in the Recommendation in accordance with Article 7 of the framework Directive (see below, Section 6).

37. Whilst a prospective analysis of market conditions may in some cases lead to a market definition different from that resulting from a market analysis based on past behaviour [22], NRAs should nonetheless seek to preserve, where possible, consistency in the methodology adopted between, on the one hand, market definitions developed for the purposes of *ex-ante* regulation, and on the other hand, market definitions developed for the purposes of the application of the competition rules. Nevertheless, as stated in Article 15(1) of the framework Directive and Section 1 of the guidelines, markets defined under sector-specific regulation are defined without prejudice to markets that may be defined in specific cases under competition law.

2.2. Main criteria for defining the relevant market

38. The extent to which the supply of a product or the provision of a service in a given geographical area constitutes the relevant market depends on the existence of competitive constraints on the price-setting behaviour of the producer(s) or service provider(s)

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concerned. There are two main competitive constraints to consider in assessing the behaviour of undertakings on the market, (i) demand-side; and (ii) supply-side substitution. A third source of competitive constraint on an operator's behaviour exists, namely potential competition. The difference between potential competition and supply-substitution lies in the fact that supply-side substitution responds promptly to a price increase whereas potential entrants may need more time before starting to supply the market. Supply substitution involves no additional significant costs whereas potential entry occurs at significant sunk costs ([23]). The existence of potential competition should thus be examined for the purpose of assessing whether a market is effectively competitive within the meaning of the framework Directive, that is whether there exist undertakings with SMP ([24]).

39. Demand-side substitutability is used to measure the extent to which consumers are prepared to substitute other services or products for the service or product in question ([25]), whereas supply-side substitutability indicates whether suppliers other than those offering the product or services in question would switch in the immediate to short term their line of production or offer the relevant products or services without incurring significant additional costs.

40. One possible way of assessing the existence of any demand and supply-side substitution is to apply the so-called 'hypothetical monopolist test' ([26]). Under this test, an NRA should ask what would happen if there were a small but significant, lasting increase in the price of a given product or service, assuming that the prices of all other products or services remain constant (hereafter, 'relative price increase'). While the significance of a price increase will depend on each individual case, in practice, NRAs should normally consider customers' (consumers or undertakings) reactions to a permanent price increase of between 5 to 10 % ([27]). The responses by consumers or undertakings concerned will aid in determining whether substitutable products do exist and, if so, where the boundaries of the relevant product market should be delineated ([28]).

41. As a starting point, an NRA should apply this test firstly to an electronic communications service or product offered in a given geographical area, the characteristics of which may be such as to justify the imposition of regulatory obligations, and having done so, add additional products or areas depending on whether competition from those products or areas constrains the price of the main product or service in question. Since a relative price increase of a set of products ([29]) is likely to lead to some sales being lost, the key issue is to determine whether the loss of sales would be sufficient to offset the increased profits which would otherwise be made from sales made following the price increase. Assessing the demand-side and supply-side substitution provides a way of measuring the quantity of the sales likely to be lost and consequently of determining the scope of the relevant market.

42. In principle, the 'hypothetical monopolist test' is relevant only with regard to products or services, the price of which is freely determined and not subject to regulation. Thus, the working assumption will be that current prevailing prices are set at competitive levels. If, however, a service or product is offered at a regulated, cost-based price, then such price is presumed, in the absence of indications to the contrary, to be set at what would otherwise be a competitive level and should therefore be taken as the starting point for applying the 'hypothetical monopolist test' ([30]). In theory, if the demand elasticity of a given product or service is significant, even at relative competitive prices, the firm in question lacks market power. If, however, elasticity is high even at current prices, that may mean only that the firm in question has already exercised market power to the point that further price increases will not increase its profits. In this case, the application of the hypothetical monopoly test may lead to a different market definition from that which would be produced if the prices were set at a competitive level ([31]). Any assessment of market definition must therefore take into account this potential difficulty. However, NRAs should proceed on the basis that the prevailing price levels provide a reasonable basis from which to start the relevant analysis unless there is evidence that this is not in fact the case.

43. If an NRA chooses to have recourse to the hypothetical monopolist test, it should then apply this test up to the point where it can be established that a relative price increase within the geographic and product markets defined will not lead consumers to switch to readily available substitutes or to suppliers located in other areas.

2.2.1. *The relevant product/service market*

44. According to settled case-law, the relevant product/service market comprises all those products or services that are sufficiently interchangeable or substitutable, not only in terms of their objective characteristics, by virtue of which they are particularly suitable for satisfying the constant needs of consumers, their prices or their intended use, but also in terms of the conditions of competition and/or the structure of supply and demand on the market in question ([32]). Products or services which are only to a small, or relative degree interchangeable with each other do not form part of the same market ([33]). NRAs should thus commence the exercise of defining the relevant product or service market by grouping together products or services that are used by consumers for the same purposes (end use).

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45. Although the aspect of the end use of a product or service is closely related to its physical characteristics, different kind of products or services may be used for the same end. For instance, consumers may use dissimilar services such as cable and satellite connections for the same purpose, namely to access the Internet. In such a case, both services (cable and satellite access services) may be included in the same product market. Conversely, paging services and mobile telephony services, which may appear to be capable of offering the same service, that is, dispatching of two-way short messages, may be found to belong to distinct product markets in view of their different perceptions by consumers as regards their functionality and end use.

46. Differences in pricing models and offerings for a given product or service may also imply different groups of consumers. Thus, by looking into prices, NRAs may define separate markets for business and residential customers for essentially the same service. For instance, the ability of operators engaged in providing international retail electronic communications services to discriminate between residential and business customers, by applying different sets of prices and discounts, has led the Commission to decide that these two groups form separate markets as far as such services are concerned (see below). However, in order for products to be viewed as demand-side substitutes it is not necessary that they are offered at the same price. A low quality product or service sold at a low price could well be an effective substitute to a higher quality product sold at higher prices. What matters in this case is the likely responses of consumers following a relative price increase [34].

47. Furthermore, product substitutability between different electronic communications services will arise increasingly through the convergence of various technologies. Use of digital systems leads to an increasing similarity in the performance and characteristics of network services using distinct technologies. A packet-switched network, for instance, such as Internet, may be used to transmit digitised voice signals in competition with traditional voice telephony services [35].

48. In order, therefore, to complete the market-definition analysis, an NRA, in addition to considering products or services whose objective characteristics, prices and intended use make them sufficiently interchangeable, should also examine, where necessary, the prevailing conditions of demand and supply substitution by applying the hypothetical monopolist test.

2.2.1.1. Demand-side substitution

49. Demand-side substitution enables NRAs to determine the substitutable products or range of products to which consumers could easily switch in case of a relative price increase. In determining the existence of demand substitutability, NRAs should make use of any previous evidence of consumers' behaviour. Where available, an NRA should examine historical price fluctuations in potentially competing products, any records of price movements, and relevant tariff information. In such circumstances evidence showing that consumers have in the past promptly shifted to other products or services, in response to past price changes, should be given appropriate consideration. In the absence of such records, and where necessary, NRAs will have to seek and assess the likely response of consumers and suppliers to a relative price increase of the service in question.

50. The possibility for consumers to substitute a product or a service for another because of a small, but significant lasting price increase may, however, be hindered by considerable switching costs. Consumers who have invested in technology or made any other necessary investments in order to receive a service or use a product may be unwilling to incur any additional costs involved in switching to an otherwise substitutable service or product. In the same vein, customers of existing providers may also be 'locked in' by long-term contracts or by the prohibitively high cost of switching terminals. Accordingly, in a situation where end users face significant switching costs in order to substitute product A for product B, these two products should not be included in the same relevant market [36].

51. Demand substitutability focuses on the interchangeable character of products or services from the buyer's point of view. Proper delineation of the product market may, however, require further consideration of potential substitutability from the supply side.

2.2.1.2. Supply-side substitution

52. In assessing the scope for supply substitution, NRAs may also take into account the likelihood that undertakings not currently active on the relevant product market may decide to enter the market, within a reasonable time frame [37], following a relative price increase, that is, a small but significant, lasting price increase. In circumstances where the overall costs of switching production to the product in question are relatively negligible, then that product may be incorporated into the product market definition. The fact that a rival firm possesses some of the assets required to provide a given service is immaterial if significant additional investment is needed to market and offer profitably the services in question [38]. Furthermore, NRAs will need to ascertain whether a given supplier would actually use or switch its productive assets to produce the relevant product or offer the relevant service (for instance, whether their capacity is committed under long-term supply agreements, etc.). Mere hypothetical supply-side substitution is not sufficient for the purposes of market definition.

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53. Account should also be taken of any existing legal, statutory or other regulatory requirements which could defeat a time-efficient entry into the relevant market and as a result discourage supply-side substitution. For instance, delays and obstacles in concluding interconnection or co-location agreements, negotiating any other form of network access, or obtaining rights of ways for network expansion ([39]), may render unlikely in the short term the provision of new services and the deployment of new networks by potential competitors.

54. As can been seen from the above considerations, supply substitution may serve not only for defining the relevant market but also for identifying the number of market participants.

2.2.2. *Geographic market*

55. Once the relevant product market is identified, the next step to be undertaken is the definition of the geographical dimension of the market. It is only when the geographical dimension of the product or service market has been defined that a NRA may properly assess the conditions of effective competition therein.

56. According to established case-law, the relevant geographic market comprises an area in which the undertakings concerned are involved in the supply and demand of the relevant products or services, in which area the conditions of competition are similar or sufficiently homogeneous and which can be distinguished from neighbouring areas in which the prevailing conditions of competition are appreciably different ([40]). The definition of the geographic market does not require the conditions of competition between traders or providers of services to be perfectly homogeneous. It is sufficient that they are similar or sufficiently homogeneous, and accordingly, only those areas in which the conditions of competition are 'heterogeneous' may not be considered to constitute a uniform market ([41]).

57. The process of defining the limits of the geographic market proceeds along the same lines as those discussed above in relation to the assessment of the demand and supply-side substitution in response to a relative price increase.

58. Accordingly, with regard to demand-side substitution, NRAs should assess mainly consumers' preferences as well as their current geographic patterns of purchase. In particular, linguistic reasons may explain why certain services are not available or marketed in different language areas. As far as supply-side substitution is concerned, where it can be established that operators which are not currently engaged or present on the relevant market, will, however, decide to enter that market in the short term in the event of a relative price increase, then the market definition should be expanded to incorporate those 'outside' operators.

59. In the electronic communications sector, the geographical scope of the relevant market has traditionally been determined by reference to two main criteria ([42]):

(a) the area covered by a network ([43]); and

(b) the existence of legal and other regulatory instruments ([44]).

60. On the basis of these two main criteria ([45]), geographic markets can be considered to be local, regional, national or covering territories of two or more countries (for instance, pan-European, EEA-wide or global markets).

2.2.3. *Other issues of market definition*

61. For the purposes of *ex-ante* regulation, in certain exceptional cases, the relevant market may be defined on a route-by-route basis. In particular, when considering the dimension of markets for international retail or wholesale electronic communications services, it may be appropriate to treat paired countries or paired cities as separate markets ([46]). Clearly, from the demand side, the delivery of a call to one country is not a substitute for the delivery of the same to another country. On the other hand, the question of whether indirect transmission services, that is, re-routing or transit of the same call via a third country, represent effective supply-side substitutes depends on the specificities of the market and should be decided on a case-by-case basis ([47]). However, a market for the provision of services on a bilateral route would be national in scope since supply and demand patterns in both ends of the route would most likely correspond to different market structures ([48]).

62. In its Notice on market definition, the Commission drew attention to certain cases where the boundaries of the relevant market may be expanded to take into consideration products or geographical areas which, although not directly substitutable, should be included in the market definition because of so-called 'chain substitutability' ([49]). In essence, chain substitutability occurs where it can be demonstrated that although products A and C are not directly substitutable, product B is a substitute for both product A and product C and therefore products A and C may be in the same product market since their pricing might be constrained by the substitutability of product B. The same reasoning also applies for defining the geographic market. Given the inherent risk of unduly widening the scope of the relevant market, findings of chain substitutability should be adequately substantiated ([50]).

2.3. The Commission's own practice

63. The Commission has adopted a number of decisions under Regulation No 17 and the merger control Regulation relating to the electronic communications sector. These decisions may be of particular relevance for NRAs with regard to the methodology applied by the Commission in defining the relevant market [51]. As stated above, however, in a sector characterised by constant innovation and rapid technological convergence, it is clear that any current market definition runs the risk of becoming inaccurate or irrelevant in the near future [52]. Furthermore, markets defined under competition law are without prejudice to markets defined under the new regulatory framework as the context and the timeframe within which a market analysis is conducted may be different [53].

64. As stated in the Access notice, there are in the electronic communications sector at least two main types of relevant markets to consider, that of services provided to end users (services market) and that of access to facilities necessary to provide such services (access market) [54]. Within these two broad market definitions further market distinctions may be made depending on demand and supply side patterns.

65. In particular, in its decision-making practice, the Commission will normally make a distinction between the provision of services and the provision of underlying network infrastructure. For instance, as regards the provision of infrastructure, the Commission has identified separate markets for the provision of local loop, long distance and international infrastructure [55]. As regards fixed services, the Commission has distinguished between subscriber (retail) access to switched voice telephony services (local, long distance and international), operator (wholesale) access to networks (local, long distance and international) and business data communications services [56]. In the market for fixed telephony retail services, the Commission has also distinguished between the initial connection and the monthly rental [57]. Retail services are offered to two distinct classes of consumers, namely, residential and business users, the latter possibly being broken down further into a market for professional, small and medium sized business customers and another for large businesses [58]. With regard to fixed telephony retail services offered to residential users, demand and supply patterns seem to indicate that two main types of services are currently being offered, traditional fixed telephony services (voice and narrowband data transmissions) on the one hand, and high speed communications services (currently in the form of xDSL services) on the other hand [59].

66. As regards the provision of mobile communications services, the Commission has found that, from a demand-side point of view, mobile telephony services and fixed telephony services constitute separate markets [60]. Within the mobile market, evidence gathered from the Commission has indicated that the market for mobile communications services encompasses both GSM 900 and GSM 1800 and possibly analogue platforms [61].

67. The Commission has found that with regard to the 'access' market, the latter comprises all types of infrastructure that can be used for the provision of a given service [62]. Whether the market for network infrastructures should be divided into as many separate submarkets as there are existing categories of network infrastructure, depends clearly on the degree of substitutability among such (alternative) networks [63]. This exercise should be carried out in relation to the class of users to which access to the network is provided. A distinction should, therefore, be made between provision of infrastructure to other operators (wholesale level) and provision to end users (retail level) [64]. At the retail level, a further segmentation may take place between business and residential customers [65].

68. When the service to be provided concerns only end users subscribed to a particular network, access to the termination points of that network may well constitute the relevant product market. This will not be the case if it can be established that the same services may be offered to the same class of consumers by means of alternative, easily accessible competing networks. For example, in its Communication on unbundling the local loop [66], the Commission stated that although alternatives to the PSTN for providing high speed communications services to residential consumers exist (fibre optic networks, wireless local loops or upgradable TV networks), none of these alternatives may be considered as a substitute to the fixed local loop infrastructure [67]. Future innovative and technological changes may, however, justify different conclusions [68].

69. Access to mobile networks may also be defined by reference to two potentially separate markets, one for call origination and another for call termination. In this respect, the question whether the access market to mobile infrastructure relates to access to an individual mobile network or to all mobile networks, in general, should be decided on the basis of an analysis of the structure and functioning of the market [69].

3. ASSESSING SIGNIFICANT MARKET POWER (DOMINANCE)

70. According to Article 14 of the framework Directive 'an undertaking shall be deemed to have significant market power if, either individually or jointly with others, it enjoys a position equivalent to dominance, that is to say a position of economic strength affording it the

power to behave to an appreciable extent independently of competitors customers and ultimately consumers'. This is the definition that the Court of Justice case-law ascribes to the concept of dominant position in Article 82 of the Treaty [70]. The new framework has aligned the definition of SMP with the Court's definition of dominance within the meaning of Article 82 of the Treaty [71]. Consequently, in applying the new definition of SMP, NRAs will have to ensure that their decisions are in accordance with the Commission's practice and the relevant jurisprudence of the Court of Justice and the Court of First Instance on dominance [72]. However, the application of the new definition of SMP, *ex-ante*, calls for certain methodological adjustments to be made regarding the way market power is assessed. In particular, when assessing *ex-ante* whether one or more undertakings are in a dominant position in the relevant market, NRAs are, in principle, relying on different sets of assumptions and expectations than those relied upon by a competition authority applying Article 82, *ex post*, within a context of an alleged committed abuse [73]. Often, the lack of evidence or of records of past behaviour or conduct will mean that the market analysis will have to be based mainly on a prospective assessment. The accuracy of the market analysis carried out by NRAs will thus be conditioned by information and data existing at the time of the adoption of the relevant decision.

71. The fact that an NRA's initial market predictions do not finally materialise in a given case does not necessarily mean that its decision at the time of its adoption was inconsistent with the Directive. In applying *ex ante* the concept of dominance, NRAs must be accorded discretionary powers correlative to the complex character of the economic, factual and legal situations that will need to be assessed. In accordance with the framework Directive, market assessments by NRAs will have to be undertaken on a regular basis. In this context, therefore, NRAs will have the possibility to react at regular intervals to any market developments and to take any measure deemed necessary.

3.1. **Criteria for assessing SMP**

72. As the Court has stressed, a finding of a dominant position does not preclude some competition in the market. It only enables the undertaking that enjoys such a position, if not to determine, at least to have an appreciable effect on the conditions under which that competition will develop, and in any case to act in disregard of any such competitive constraint so long as such conduct does not operate to its detriment [74].

73. In an *ex-post* analysis, a competition authority may be faced with a number of different examples of market behaviour each indicative of market power within the meaning of Article 82. However, in an *ex-ante* environment, market power is essentially measured by reference of the power of the undertaking concerned to raise prices by restricting output without incurring a significant loss of sales or revenues.

74. The market power of an undertaking can be constrained by the existence of potential competitors [75]. An NRA should thus take into account the likelihood that undertakings not currently active on the relevant product market may in the medium term decide to enter the market following a small but significant non-transitory price increase. Undertakings which, in case of such a price increase, are in a position to switch or extend their line of production/services and enter the market should be treated by NRAs as potential market participants even if they do not currently produce the relevant product or offer the relevant service.

75. As explained in the paragraphs below, a dominant position is found by reference to a number of criteria and its assessment is based, as stated above, on a forward-looking market analysis based on existing market conditions. Market shares are often used as a proxy for market power. Although a high market share alone is not sufficient to establish the possession of significant market power (dominance), it is unlikely that a firm without a significant share of the relevant market would be in a dominant position. Thus, undertakings with market shares of no more than 25 % are not likely to enjoy a (single) dominant position on the market concerned [76]. In the Commission's decision-making practice, single dominance concerns normally arise in the case of undertakings with market shares of over 40 %, although the Commission may in some cases have concerns about dominance even with lower market shares [77], as dominance may occur without the existence of a large market share. According to established case-law, very large market shares — in excess of 50 % — are in themselves, save in exceptional circumstances, evidence of the existence of a dominant position [78]. An undertaking with a large market share may be presumed to have SMP, that is, to be in a dominant position, if its market share has remained stable over time [79]. The fact that an undertaking with a significant position on the market is gradually losing market share may well indicate that the market is becoming more competitive, but it does not preclude a finding of significant market power. On the other hand, fluctuating market shares over time may be indicative of a lack of market power in the relevant market.

76. As regards the methods used for measuring market size and market shares, both volume sales and value sales provide useful information for market measurement [80]. In the case of bulk products preference is given to volume whereas in the case of differentiated products (i.e. branded products) sales in value and their associated market share will often be considered to reflect better the relative position and strength of each provider. In bidding markets the number of bids won and lost may also be used as approximation of market shares [81].

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77. The criteria to be used to measure the market share of the undertaking(s) concerned will depend on the characteristics of the relevant market. It is for NRAs to decide which are the criteria most appropriate for measuring market presence. For instance, leased lines revenues, leased capacity or numbers of leased line termination points are possible criteria for measuring an undertaking's relative strength on leased lines markets. As the Commission has indicated, the mere number of leased line termination points does not take into account the different types of leased lines that are available on the market — ranging from analogue voice quality to high-speed digital leased lines, short distance to long distance international leased lines. Of the two criteria, leased lines revenues may be more transparent and less complicated to measure. Likewise, retail revenues, call minutes or numbers of fixed telephone lines or subscribers of public telephone network operators are possible criteria for measuring the market shares of undertakings operating in these markets ([82]). Where the market defined is that of interconnection, a more realistic measurement parameter would be the revenues accrued for terminating calls to customers on fixed or mobile networks. This is so because the use of revenues, rather than for example call minutes, takes account of the fact that call minutes can have different values (i.e. local, long distance and international) and provides a measure of market presence that reflects both the number of customers and network coverage ([83]). For the same reasons, the use of revenues for terminating calls to customers of mobile networks may be the most appropriate means to measure the market presence of mobile network operators ([84]).

78. It is important to stress that the existence of a dominant position cannot be established on the sole basis of large market shares. As mentioned above, the existence of high market shares simply means that the operator concerned might be in a dominant position. Therefore, NRAs should undertake a thorough and overall analysis of the economic characteristics of the relevant market before coming to a conclusion as to the existence of significant market power. In that regard, the following criteria can also be used to measure the power of an undertaking to behave to an appreciable extent independently of its competitors, customers and consumers. These criteria include amongst others:

— overall size of the undertaking,

— control of infrastructure not easily duplicated,

— technological advantages or superiority,

— absence of or low countervailing buying power,

— easy or privileged access to capital markets/financial resources,

— product/services diversification (e.g. bundled products or services),

— economies of scale,

— economies of scope,

— vertical integration,

— a highly developed distribution and sales network,

— absence of potential competition,

— barriers to expansion.

79. A dominant position can derive from a combination of the above criteria, which taken separately may not necessarily be determinative.

80. A finding of dominance depends on an assessment of ease of market entry. In fact, the absence of barriers to entry deters, in principle, independent anti-competitive behaviour by an undertaking with a significant market share. In the electronic communications sector, barriers to entry are often high because of existing legislative and other regulatory requirements which may limit the number of available licences or the provision of certain services (i.e. GSM/DCS or 3G mobile services). Furthermore, barriers to entry exist where entry into the relevant market requires large investments and the programming of capacities over a long time in order to be profitable ([85]). However, high barriers to entry may become less relevant with regard to markets characterised by on-going technological progress. In electronic communications markets, competitive constraints may come from innovative threats from potential competitors that are not currently in the market. In such markets, the competitive assessment should be based on a prospective, forward-looking approach.

81. As regards the relevance of the notion of 'essential facilities' for the purposes of applying the new definition of SMP, there is for the moment no jurisprudence in relation to the electronic communications sector. However, this notion, which is mainly relevant with regard to the existence of an abuse of a dominant position under Article 82 of the EC Treaty, is less relevant with regard to the *ex-ante* assessment of SMP within the meaning of Article 14 of the framework Directive. In particular, the doctrine of 'essential facilities' is complementary to existing general obligations imposed on dominant undertaking, such as the obligation not to discriminate among customers and has been applied in cases under Article 82 in exceptional circumstances, such as where the refusal to supply or to grant access to third parties would limit or prevent the emergence of new markets, or new products, contrary to Article 82(b) of the Treaty. It has thus primarily been associated with

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access issues or cases involving a refusal to supply or to deal under Article 82 of the Treaty, without the presence of any discriminatory treatment. Under existing case-law, a product or service cannot be considered 'necessary' or 'essential' unless there is no real or potential substitute. Whilst it is true that an undertaking which is in possession of an 'essential facility' is by definition in a dominant position on any market for that facility, the contrary is not always true. The fact that a given facility is not 'essential' or 'indispensable' for an economic activity on some distinct market, within the meaning of the existing case-law ([86]) does not mean that the owner of this facility might not be in a dominant position. For instance, a network operator can be in a dominant position despite the existence of alternative competing networks if the size or importance of its network affords him the possibility to behave independently from other network operators ([87]). In other words, what matters is to establish whether a given facility affords its owner significant market power in the market without thus being necessary to further establish that the said facility can also be considered 'essential' or 'indispensable' within the meaning of existing case-law.

82. It follows from the foregoing that the doctrine of the 'essential facilities' is less relevant for the purposes of applying *ex ante* Article 14 of the framework Directive than applying ex-post Article 82 of the EC Treaty.

3.1.1. *Leverage of market power*

83. According to Article 14(3) of the framework Directive, 'where an undertaking has significant market power on a specific market, it may also be deemed to have significant market power on a closely related market, where the links between the two markets are such as to allow the market power held in one market to be leveraged into the other market, thereby strengthening the market power of the undertaking'.

84. This provision is intended to address a market situation comparable to the one that gave rise to the Court's judgment in *Tetra Pak II* ([88]). In that case, the Court decided that an undertaking that had a dominant position in one market, and enjoyed a leading position on a distinct but closely associated market, was placed as a result in a situation comparable to that of holding a dominant position on the markets in question taken as a whole. Thanks to its dominant position on the first market, and its market presence on the associated, secondary market, an undertaking may thus leverage the market power which it enjoys in the first market and behave independently of its customers on the latter market ([89]). Although in Tetra Pak the markets taken as a whole in which Tetra Pak was found to be dominant were horizontal, close associative links, within the meaning of the Court's case-law, will most often be found in vertically integrated markets. This is often the case in the telecommunications sector, where an operator often has a dominant position on the infrastructure market and a significant presence on the downstream, services market ([90]). Under such circumstances, an NRA may consider it appropriate to find that such operator has SMP on both markets taken together. However, in practice, if an undertaking has been designated as having SMP on an upstream wholesale or access market, NRAs will normally be in a position to prevent any likely spill-over or leverage effects downstream into the retail or services markets by imposing on that undertaking any of the obligations provided for in the access Directive which may be appropriate to avoid such effects. Therefore, it is only where the imposition of *ex-ante* obligations on an undertaking which is dominant in the (access) upstream market would not result in effective competition on the (retail) downstream market that NRAs should examine whether Article 14(3) may apply.

85. The foregoing considerations are also relevant in relation to horizontal markets ([91]). Moreover, irrespective of whether the markets under consideration are vertical or horizontal, both markets should be electronic communications markets within the meaning of Article 2 of the framework Directive and both should display such characteristics as to justify the imposition of *ex-ante* regulatory obligations ([92]).

3.1.2. *Collective dominance*

86. Under Article 82 of the EC Treaty, a dominant position can be held by one or more undertakings ('collective dominance'). Article 14(2) of the framework Directive also provides that an undertaking may enjoy significant market power, that is, it may be in a dominant position, either individually or jointly with others.

87. In the Access notice, the Commission had stated that, although at the time both its own practice and the case-law of the Court were still developing, it would consider two or more undertakings to be in a collective dominant position when they had substantially the same position vis-à-vis their customers and competitors as a single company has if it is in a dominant position, provided that no effective competition existed between them. The lack of competition could be due, in practice, to the existence of certain links between those companies. The Commission had also stated, however, that the existence of such links was not a prerequisite for a finding of joint dominance ([93]).

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88. Since the publication of the Access notice, the concept of collective dominance has been tested in a number of decisions taken by the Commission under Regulation No 17 and under the merger control Regulation. In addition, both the Court of First Instance (CFI) and the Court of Justice of the European Communities (ECJ) have given judgments which have contributed to further clarifying the exact scope of this concept.

3.1.2.1. The jurisprudence of the CFI/ECJ

89. The expression 'one or more undertakings' in Article 82 of the EC Treaty implies that a dominant position may be held by two or more economic entities which are legally and economically independent of each other ([94]).

90. Until the ruling of the ECJ in *Compagnie maritime belge* ([95]) and the ruling of the CFI in *Gencor* ([96]) (see below), it might have been argued that a finding of collective dominance was based on the existence of economic links, in the sense of structural links, or other factors which could give rise to a connection between the undertakings concerned ([97]). The question of whether collective dominance could also apply to an oligopolistic market, that is a market comprised of few sellers, in the absence of any kind of links among the undertakings present in such a market, was first raised in Gencor. The case concerned the legality of a decision adopted by the Commission under the merger control Regulation prohibiting the notified transaction on the grounds that it would lead to the creation of a duopoly market conducive to a situation of oligopolistic dominance ([98]). Before the CFI, the parties argued that the Commission had failed to prove the existence of 'links' between the members of the duopoly within the meaning of the existing case-law.

91. The CFI dismissed the application by stating, *inter alia*, that there was no legal precedent suggesting that the notion of 'economic links' was restricted to the notion of structural links between the undertakings concerned: According to the CFI, 'there is no reason whatsoever in legal or economic terms to exclude from the notion of economic links the relationship of interdependence existing between the parties to a tight oligopoly within which, in a market with the appropriate characteristics, in particular in terms of market concentration, transparency and product homogeneity, those parties are in a position to anticipate one another's behaviour and are therefore strongly encouraged to align their conduct in the market, in particular in such a way as to maximise their joint profits by restricting production with a view to increasing prices. In such a context, each trader is aware that highly competitive action on its part designed to increase its market share (for example a price cut) would provoke identical action by the others, so that it would derive no benefit from its initiative. All the traders would thus be affected by the reduction in price *levels*' ([99]). As the Court pointed out, market conditions may be such that 'each undertaking may become aware of common interests and, in particular, cause prices to increase without having to enter into an agreement or resort to concerted practice' ([100]).

92. The CFI's ruling in Gencor was later endorsed by the ECJ in Compagnie maritime belge, where the Court gave further guidance as to how the term of collective dominance should be understood and as to which conditions must be fulfilled before such finding can be made. According to the Court, in order to show that two or more undertakings hold a joint dominant position, it is necessary to consider whether the undertakings concerned together constitute a collective entity vis-à-vis their competitors, their trading partners and their consumers on a particular market ([101]). This will be the case when (i) there is no effective competition among the undertakings in question; and (ii) the said undertakings adopt a uniform conduct or common policy in the relevant market ([102]). Only when that question is answered in the affirmative, is it appropriate to consider whether the collective entity actually holds a dominant position ([103]). In particular, it is necessary to ascertain whether economic links exist between the undertakings concerned which enable them to act independently of their competitors, customers and consumers. The Court recognised that an implemented agreement, decision or concerted practice (whether or not covered by an exemption under Article 81(3) of the Treaty) may undoubtedly result in the undertakings concerned being linked in a such way that their conduct on a particular market on which they are active results in them being perceived as a collective entity vis-à-vis their competitors, their trading partners and consumers ([104]).

93. The mere fact, however, that two or more undertakings are linked by an agreement, a decision of associations of undertakings or a concerted practice within the meaning of Article 81(1) of the Treaty does not, of itself, constitute a necessary basis for such a finding. As the Court stated, 'a finding of a collective dominant position may also be based on other connecting factors and would depend on an economic assessment and, in particular, on an assessment of the structure of the market in question' ([105]).

94. It follows from the Gencor and Compagnie maritime belge judgments that, although the existence of structural links can be relied upon to support a finding of a collective dominant position, such a finding can also be made in relation to an oligopolistic or highly concentrated market whose structure alone in particular, is conducive to coordinated effects on the relevant market ([106]).

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3.1.2.2. The Commission's decision-making practice and Annex II of the framework Directive

95. In a number of decisions adopted under the merger control Regulation, the Commission considered the concept of collective dominance. It sought in those cases to ascertain whether the structure of the oligopolistic markets in question was conducive to coordinated effects on those markets ([107]).

96. When assessing *ex-ante* the likely existence or emergence of a market which is or could become conducive to collective dominance in the form of tacit coordination, NRAs, should analyse:

(a) whether the characteristics of the market makes it conducive to tacit coordination; and

(b) whether such form of coordination is sustainable that is, (i) whether any of the oligopolists have the ability and incentive to deviate from the coordinated outcome, considering the ability and incentives of the non-deviators to retaliate; and (ii) whether buyers/fringe competitors/potential entrants have the ability and incentive to challenge any anti-competitive coordinated outcome ([108]).

97. This analysis is facilitated by looking at a certain number of criteria which are summarised in Annex II of the framework Directive, which have also been used by the Commission in applying the notion of collective dominance under the merger control Regulation. According to this Annex, 'two or more undertakings can be found to be in a joint dominant position within the meaning of Article 14 if, even in the absence of structural or other links between them, they operate in a market, the structure of which is considered to be conducive to coordinated effects ([109]). Without prejudice to the case-law of the Court of Justice on joint dominance, this is likely to be the case where the market satisfies a number of appropriate characteristics, in particular in terms of market concentration, transparency and other characteristics mentioned below:

— mature market,

— stagnant or moderate growth on the demand side,

— low elasticity of demand,

— homogeneous product,

— similar cost structures,

— similar market shares,

— lack of technical innovation, mature technology,

— absence of excess capacity,

— high barriers to entry,

— lack of countervailing buying power,

— lack of potential competition,

— various kind of informal or other links between the undertakings concerned,

— retaliatory mechanisms,

— lack or reduced scope for price competition'.

98. Annex II of the framework Directive expressly states that the above is not an exhaustive list, nor are the criteria cumulative. Rather, the list is intended to illustrate the sorts of evidence that could be used to support assertions concerning the existence of a collective (oligopolistic) dominance in the form of tacit coordination ([110]). As stated above, the list also shows that the existence of structural links among the undertakings concerned is not a prerequisite for finding a collective dominant position. It is however clear that where such links exist, they can be relied upon to explain, together with any of the other abovementioned criteria, why in a given oligopolistic market coordinated effects are likely to arise. In the absence of such links, in order to establish whether a market is conducive to collective dominance in the form of tacit coordination, it is necessary to consider a number of characteristics of the market. While these characteristics are often presented in the form of the abovementioned list, it is necessary to examine all of them and to make an overall assessment rather than mechanistically applying a 'check list'. Depending on the circumstances of the case, the fact that one or another of the structural elements usually associated with collective dominance may not be clearly established is not in itself decisive to exclude the likelihood of a coordinated outcome ([111]).

99. In an oligopolistic market where most, if not all, of the abovementioned criteria are met, it should be examined whether, in particular, the market operators have a strong incentive to converge to a coordinated market outcome and refrain from reliance on competitive conduct. This will be the case where the long-term benefits of an anti-competitive conduct outweigh any short-term gains resulting from a resort to a competitive behaviour.

100. It must be stressed that a mere finding that a market is concentrated does not necessarily warrant a finding that its structure is conducive to collective dominance in the form of tacit coordination ([112]).

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101. Ultimately, in applying the notion of collective dominance in the form of tacit coordination, the criteria which will carry the most sway will be those which are critical to a coordinated outcome in the specific market under consideration. For instance, in Case COMP/M.2499 — Norske Skog/Parenco/Walsum, the Commission came to the conclusion that even if the markets for newsprint and wood-containing magazine paper were concentrated, the products were homogeneous, demand was highly inelastic, buyer power was limited and barriers to entry were high, nonetheless the limited stability of market shares, the lack of symmetry in costs structures and namely, the lack of transparency of investments decisions and the absence of a credible retaliation mechanism rendered unlikely and unsustainable any possibility of tacit coordination among the oligopolists ([113]).

3.1.2.3. Collective dominance and the telecommunications sector

102. In applying the notion of collective dominance, NRAs may also take into consideration decisions adopted under the merger control Regulation in the electronic communications sector, in which the Commission has examined whether any of the notified transactions could give rise to a finding of collective dominance.

103. In *MCI WorldCom/Sprint*, the Commission examined whether the merged entity together with Concert Alliance could be found to enjoy a collective dominant position on the market for global telecommunications services (GTS). Given that operators on that market competed on a bid basis where providers were selected essentially in the first instances of the bidding process on the basis of their ability to offer high quality, tailor-made sophisticated services, and not on the basis of prices, the Commission's investigation was focused on the incentives for market participants to engage in parallel behaviour as to who wins what bid (and who had won what bids) ([114]). After having examined in depth the structure of the market (homogenous product, high barriers of entry, customers countervailing power, etc.) the Commission concluded that it was not able to show absence of competitive constraints from actual competitors, a key factor in examining whether parallel behaviour can be sustained, and thus decided not to pursue further its objections in relation to that market ([115]).

104. In *BT/Esat* ([116]), one of the issues examined by the Commission was whether market conditions in the Irish market for dial-up Internet access lent themselves to the emergence of a duopoly consisting of the incumbent operator, Eircom, and the merged entity. The Commission concluded that this was not the case for the following reasons. First, market shares were not stable; second, demand was doubling every six months; third, internet access products were not considered homogeneous; and finally, technological developments were one of the main characteristics of the market ([117]).

105. In *Vodafone/Airtouch* ([118]), the Commission found that the merged entity would have joint control of two of the four mobile operators present on the German mobile market (namely D2 and E-Plus, the other two being T-Mobil and VIAG Interkom). Given that entry into the market was highly regulated, in the sense that licences were limited by reference to the amount of available radio frequencies, and that market conditions were transparent, it could not be ruled out that such factors could lead to the emergence of a duopoly conducive to coordinated effects ([119]).

106. In *France Telecom/Orange* the Commission found that, prior to the entry of Orange into the Belgian mobile market, the two existing players, Proximus and Mobistar, were in a position to exercise joint dominance. As the Commission noted, for the four years preceding Orange's entry, both operators had almost similar and transparent pricing, their prices following exactly the same trends ([120]). In the same decision the Commission further dismissed claims by third parties as to the risk of a collective dominant position of Vodafone and France Telecom in the market for the provision of pan-European mobile services to internationally mobile customers. Other than significant asymmetries between the market shares of the two operators, the market was considered to be emerging, characterised by an increasing demand and many types of different services on offer and on price ([121]).

4. IMPOSITION, MAINTENANCE, AMENDMENT OR WITHDRAWAL OF OBLIGATIONS UNDER THE REGULATORY FRAMEWORK

107. Section 3 of these guidelines dealt with the analysis of relevant markets that NRAs must carry out under Article 16 of the framework Directive to determine whether a market is effectively competitive, i.e. whether there are undertakings in that market who are in a dominant position. This section aims to provide guidance for NRAs on the action they should take following that analysis, i.e. the imposition, maintenance, amendment or withdrawal, as appropriate, of specific regulatory obligations on undertakings designated as having SMP. This section also describes the circumstances in which similar obligations than those that can be imposed on SMP operators may, exceptionally, be imposed on undertakings who have not been designated as having SMP.

108. The specific regulatory obligations which may be imposed on SMP undertakings can apply both to wholesale and retail markets. In principle, the obligations related to wholesale markets are set out in Articles 9 to 13 of the access Directive. The obligations related to retail markets are set out in Articles 17 to 19 of the universal service Directive.

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109. The obligations set out in the access Directive are: transparency (Article 9); non-discrimination (Article 10); accounting separation (Article 11), obligations for access to and use of specific network facilities (Article 12), and price control and cost accounting obligations (Article 13). In addition, Article 8 of the access Directive provides that NRAs may impose obligations outside this list. In order to do so, they must submit a request to the Commission, which will take a decision, after seeking the advice of the Communications Committee, as to whether the NRA concerned is permitted to impose such obligations.

110. The obligations set out in the universal service Directive are: regulatory controls on retail services (Article 17), availability of the minimum set of leased lines (Article 18 and Annex VII) and carrier selection and preselection (Article 19).

111. Under the regulatory framework, these obligations should only be imposed on undertakings which have been designated as having SMP in a relevant market, except in certain defined cases, listed in Section 4.3.

4.1. Imposition, maintenance, amendment or withdrawal of obligations on SMP operators

112. As explained in Section 1, the notion of effective competition means that there is no undertaking with dominance on the relevant market. In other words, a finding that a relevant market is effectively competitive is, in effect, a determination that there is neither single nor joint dominance on that market. Conversely, a finding that a relevant market is not effectively competitive is a determination that there is single or joint dominance on that market.

113. If an NRA finds that a relevant market is subject to effective competition, it is not allowed to impose obligations on any operator on that relevant market under Article 16. If the NRA has previously imposed regulatory obligations on undertaking(s) in that market, the NRA must withdraw such obligations and may not impose any new obligation on that undertaking(s). As stipulated in Article 16(3) of the framework Directive, where the NRA proposes to remove existing regulatory obligations, it must give parties affected a reasonable period of notice.

114. If an NRA finds that competition in the relevant market is not effective because of the existence of an undertaking or undertakings in a dominant position, it must designate in accordance with Article 16(4) of the framework Directive the undertaking or undertakings concerned as having SMP and impose appropriate regulatory obligations on the undertaking(s) concerned. However, merely designating an undertaking as having SMP on a given market, without imposing any appropriate regulatory obligations, is inconsistent with the provisions of the new regulatory framework, notably Article 16(4) of the framework Directive. In other words, NRAs must impose at least one regulatory obligation on an undertaking that has been designated as having SMP. Where an NRA determines the existence of more than one undertaking with dominance, i.e. that a joint dominant position exists, it should also determine the most appropriate regulatory obligations to be imposed, based on the principle of proportionality.

115. If an undertaking was previously subject to obligations under the 1998 regulatory framework, the NRA must consider whether similar obligations continue to be appropriate under the new regulatory framework, based on a new market analysis carried out in accordance with these guidelines. If the undertaking is found to have SMP in a relevant market under the new framework, regulatory obligations similar to those imposed under the 1998 regulatory framework may therefore be maintained. Alternatively, such obligations could be amended, or new obligations provided in the new framework might also be imposed, as the NRA considers appropriate.

116. Except where the Community's international commitments under international treaties prescribe the choice of regulatory obligation (see Section 4.4) or when the Directives prescribe particular remedies as under Article 18 and 19 of the universal service Directive, NRAs will have to choose between the range of regulatory obligations set out in the Directives in order to remedy a particular problem in a market found not to be effectively competitive. Where NRAs intend to impose other obligations for access and interconnection than those listed in the access Directive, they must submit a request for Commission approval of their proposed course of action. The Commission must seek the advice of the Communications Committee before taking its decision.

117. Community law, and in particular Article 8 of the framework Directive, requires NRAs to ensure that the measures they impose on SMP operators under Article 16 of the framework Directive are justified in relation to the objectives set out in Article 8 and are proportionate to the achievement of those objectives. Thus any obligation imposed by NRAs must be proportionate to the problem to be remedied. Article 7 of the framework Directive requires NRAs to set out the reasoning on which any proposed measure is based when they communicate that measure to other NRAs and to the Commission. Thus, in addition to the market analysis supporting the finding of SMP, NRAs need to include in their decisions a justification of the proposed measure in relation to the objectives of Article 8, as well as an explanation of why their decision should be considered proportionate.

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118. Respect for the principle of proportionality will be a key criterion used by the Commission to assess measures proposed by NRAs under the procedure of Article 7 of framework Directive. The principle of proportionality is well-established in Community law. In essence, the principle of proportionality requires that the means used to attain a given end should be no more than what is appropriate and necessary to attain that end. In order to establish that a proposed measure is compatible with the principle of proportionality, the action to be taken must pursue a legitimate aim, and the means employed to achieve the aim must be both necessary and the least burdensome, i.e. it must be the minimum necessary to achieve the aim.

119. However, particularly in the early stages of implementation of the new framework, the Commission would not expect NRAs to withdraw existing regulatory obligations on SMP operators which have been designed to address legitimate regulatory needs which remain relevant, without presenting clear evidence that those obligations have achieved their purpose and are therefore no longer required since competition is deemed to be effective on the relevant market. Different remedies are available in the new regulatory framework to address different identified problems and remedies should be tailored to these specified problems.

120. The Commission, when consulted as provided for in Article 7(3) of the framework Directive, will also check that any proposed measure taken by the NRAs is in conformity with the regulatory framework as a whole, and will assess the impact of the proposed measure on the single market.

121. The Commission will assist NRAs to ensure that as far as possible they adopt consistent approaches in their choice of remedies where similar situations exist in different Member States. Moreover, as noted in Article 7(2) of the framework Directive, NRAs shall seek to agree on the types of remedies best suited to address particular situations in the marketplace.

4.2. Transnational markets: joint analysis by NRAs

122. Article 15(4) of the framework Directive gives the Commission the power to issue a Decision identifying product and service markets that are transnational, covering the whole of the Community or a substantial part thereof. Under the terms of Article 16(5) of the framework Directive, the NRAs concerned must jointly conduct the market analysis and decide whether obligations need to be imposed. In practice, the European Regulators Group is expected to provide a suitable forum for such a joint analysis.

123. In general, joint analysis by NRAs would follow similar procedures (e.g. for public consultation) to those required when a single national regulatory authority is conducting a market analysis. Precise arrangements for collective analysis and decision-making will need to be drawn up.

4.3. Imposition of certain specific regulatory obligations on non-SMP operators

124. The preceding parts of this section set out the procedures whereby certain specific obligations may be imposed on SMP undertakings, under Articles 7 and 8 of the access Directive and Article 16-19 of the universal service Directive. Exceptionally, similar obligations may be imposed on operators other than those that have been designated as having SMP, in the following cases, listed in Article 8(3) of the access Directive:

— obligations covering *inter alia* access to conditional access systems, obligations to interconnect to ensure end-to-end interoperability, and access to application program interfaces and electronic programme guides to ensure accessibility to specified digital TV and radio broadcasting services (Article 5(1), 5(2) and 6 of the access Directive),

— obligations that NRAs may impose for co-location where rules relating to environmental protection, health, security or town and country planning deprive other undertakings of viable alternatives to co-location (Article 12 of the framework Directive),

— obligations for accounting separation on undertakings providing electronic communications services who enjoy special or exclusive rights in other sectors (Article 13 of the framework Directive),

— obligations relating to commitments made by an undertaking in the course of a competitive or comparative selection procedure for a right of use of radio frequency (Condition B7 of the Annex to the authorisation Directive, applied via Article 6(1) of that Directive),

— obligations to handle calls to subscribers using specific numbering resources and obligations necessary for the implementation of number portability (Articles 27, 28 and 30 of the universal service Directive),

— obligations based on the relevant provisions of the data protection Directive, and

— obligations to be imposed on non-SMP operators in order to comply with the Community's international commitments.

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4.4. Relationship to WTO commitments

125. The EC and its Member States have given commitments in the WTO in relation to undertakings that are 'major suppliers' of basic telecommunications services ([122]). Such undertakings are subject to all of the obligations set out in the EC's and its Member States' commitments in the WTO for basic telecommunications services. The provisions of the new regulatory framework, in particular relating to access and interconnection, ensure that NRAs continue to apply the relevant obligations to undertakings that are major suppliers in accordance with the WTO commitments of the EC and its Member States.

5. POWERS OF INVESTIGATION AND COOPERATION PROCEDURES FOR THE PURPOSE OF MARKET ANALYSIS

5.1. Overview

126. This section of the guidelines covers procedures in respect of an NRA's powers to obtain the information necessary to conduct a market analysis.

127. The regulatory framework contains provisions to enable NRAs to require undertakings that provide electronic communications networks and services to supply all the information, including confidential information, necessary for NRAs to assess the state of competition in the relevant markets and impose appropriate *ex-ante* obligations and thus to ensure compliance with the regulatory framework.

128. This section of the guidelines also includes guidance as to measures to ensure effective cooperation between NRAs and NCAs at national level, and among NRAs and between NRAs and the Commission at Community level. In particular this section deals with the exchange of information between those authorities.

129. Many electronic communication markets are fast-moving and their structures are changing rapidly. NRAs should ensure that the assessment of effective competition, the public consultation, and the designation of operators having SMP are all carried out within a reasonable period. Any unnecessary delay in the decision could have harmful effects on incentives for investment by undertakings in the relevant market and therefore on the interests of consumers.

5.2. Market analysis and powers of investigation

130. Under Article 16(1) of the framework Directive, NRAs must carry out an analysis of the relevant markets identified in the Recommendation and any Decision as soon as possible after their adoption or subsequent revision. The conclusions of the analysis of each of the relevant markets, together with the proposed regulatory action, must be published and a public consultation must be conducted, as described in Section 6.

131. In order to carry out their market analysis, NRAs will first need to collect all the information they consider necessary to assess market power in a given market. To the extent that such information needs to be obtained directly from undertakings, Article 11 of the authorisation Directive provides that undertakings are required by the terms of their general authorisation to supply the information necessary for NRAs to conduct a market analysis within the meaning of Article 16(2) of the framework Directive. This is reinforced by the more general obligation in Article 5(1) of the framework Directive which provides that Member States shall ensure that undertakings providing electronic communications networks and services provide all the information necessary for NRAs to ensure conformity with Community law.

132. When NRAs request information from an undertaking, they should state the reasons justifying the request and the time limit within which the information is to be provided. As provided for in Article 10(4) of the authorisation Directive, NRAs may be empowered to impose financial penalties on undertakings for failure to provide information.

133. In accordance with Article 5(4) of the framework Directive, NRAs must publish all information that would contribute to an open and competitive market, acting in accordance with national rules on public access to information and subject to Community and national rules on commercial confidentiality.

134. However, as regards information that is confidential in nature, the provisions of Article 5(3) of the framework Directive, require NRAs to ensure the confidentiality of such information in accordance with Community and national rules on business confidentiality. This confidentiality obligation applies equally to information that has been received in confidence from another public authority.

5.3. Cooperation procedures

Between NRAs and NCAs

135. Article 16(1) of the framework Directive requires NRAs to associate NCAs with the market analyses as appropriate. Member States should put in place the necessary procedures to guarantee that the analysis under Article 16 of the framework Directive is carried out effectively. As the NRAs conduct their market analyses in accordance with the methodologies of competition law, the views of NCAs in respect of the assessment of competition are highly relevant. Cooperation between NRAs and NCAs will be essential, but NRAs remain legally responsible for conducting the relevant analysis. Where under national law the tasks assigned under Article 16 of the framework Directive are carried out by two or more separate regulatory bodies, Member States should ensure clear division of tasks and set up procedures for consultation and cooperation between regulators in order to assure coherent analysis of the relevant markets.

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136. Article 3(5) of the framework Directive requires NRAs and NCAs to provide each other with the information necessary for the application of the regulatory framework, and the receiving authority must ensure the same level of confidentiality as the originating authority. NCAs should therefore provide NRAs with all relevant information obtained using the former's investigatory and enforcement powers, including confidential information.

137. Information that is considered confidential by an NCA, in accordance with Community and national rules on business confidentiality, should only be exchanged with NRAs where such exchange is necessary for the application of the provisions of the regulatory framework. The information exchanged should be limited to that which is relevant and proportionate to the purpose of such exchange.

Between the Commission and NRAs

138. For the regulatory framework to operate efficiently and effectively, it is vital that there is a high level of cooperation between the Commission and the NRAs. It is particularly important that effective informal cooperation takes place. The European Regulators Group will be of great importance in providing a framework for such cooperation, as part of its task of assisting and advising the Commission. Cooperation is likely to be of mutual benefit, by minimising the likelihood of divergences in approach between different NRAs, in particular divergent remedies to deal with the same problem ([123]).

139. In accordance with Article 5(2) of the framework Directive, NRAs must supply the Commission with information necessary for it to carry out its tasks under the Treaty. This covers information relating to the regulatory framework (to be used in verifying compatibility of NRA action with the legislation), but also information that the Commission might require, for example, in considering compliance with WTO commitments.

140. NRAs must ensure that, where they submit information to the Commission which they have requested undertakings to provide, they inform those undertakings that they have submitted it to the Commission.

141. The Commission can also make such information available to another NRA, unless the original NRA has made an explicit and reasoned request to the contrary. Although there is no legal requirement to do so, the Commission will normally inform the undertaking which originally provided the information that it has been passed on to another NRA.

Between NRAs

142. It is of the utmost importance that NRAs develop a common regulatory approach across Member States that will contribute to the development of a true single market for electronic communications. To this end, NRAs are required under Article 7(2) of the framework Directive to cooperate with each other and with the Commission in a transparent manner to ensure the consistent application, in all Member States, of the new regulatory framework. The European Regulators' Group is expected to serve as an important forum for cooperation.

143. Article 5(2) of the framework Directive also foresees that NRAs will exchange information directly between each other, as long as there is a substantiated request. This will be particularly necessary where a transnational market needs to be analysed, but it will also be required within the framework of cooperation in the European Regulators' Group. In all exchanges of information, the NRAs are required to maintain the confidentiality of information received.

6. PROCEDURES FOR CONSULTATION AND PUBLICATION OF PROPOSED NRA DECISIONS

6.1. Public consultation mechanism

144. Except in the urgent cases as explained below, an NRA that intends to take a measure which would have a significant impact on the relevant market should give the interested parties the opportunity to comment on the draft measure. To this effect, the NRA must hold a public consultation on its proposed measure. Where the draft measure concerns a decision relating to an SMP designation or non-designation it should include the following:

- the market definition used and reasons therefor, with the exception of information that is confidential in accordance with European and national law on business confidentiality,
- evidence relating to the finding of dominance, with the exception of information that is confidential in accordance with European and national law on business confidentiality together with the identification of any undertakings proposed to be designated as having SMP,
- full details of the sector-specific obligations that the NRA proposes to impose, maintain, modify or withdraw on the abovementioned undertakings together with an assessment of the proportionality of that proposed measure.

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145. The period of the consultation should be reasonable. However, NRAs' decisions should not be delayed excessively as this can impede the development of the market. For decisions related to the existence and designation of undertakings with SMP, the Commission considers that a period of two months would be reasonable for the public consultation. Different periods could be used in some cases if justified. Conversely, where a draft SMP decision is proposed on the basis of the results of an earlier consultation, the length of consultation period for these decisions may well be shorter than two months.

6.2. **Mechanisms to consolidate the internal market for electronic communications**

146. Where an NRA intends to take a measure which falls within the scope of the market definition or market analysis procedures of Articles 15 and 16 of the framework Directive, as well as when NRAs apply certain other specific Articles in the regulatory framework [124] and where the measures have an effect on trade between Member States, the NRAs must communicate the measures, together with their reasoning, to NRAs in other Member States and to the Commission in accordance with Article 7(3) of the framework Directive. It should do this at the same time as it begins its public consultation. The NRA must then give other NRAs and the Commission the chance to comment on the NRA's proposed measures, before adopting any final decision. The time available for other NRAs and the Commission to comment should be the same time period as that set by the NRA for its national public consultation, unless the latter is shorter than the minimum period of one month provided for in Article 7(3). The Commission may decide in justified circumstances to publish its comments.

147. With regard to measures that could affect trade between Member States, this should be understood as meaning measures that may have an influence, direct or indirect, actual or potential, on the pattern of trade between Member States in a manner which might create a barrier to the single European market [125]. Therefore, the notion of an effect on trade between Member States is likely to cover a broad range of measures.

148. NRAs must make public the results of the public consultation, except in the case of information that is confidential in accordance with Community and national law on business confidentiality.

149. With the exception of two specific cases, explained in the following paragraph, the NRA concerned may adopt the final measure after having taken account of views expressed during its mandatory consultation. The final measure must then be communicated to the Commission without delay.

6.3. **Commission power to require the withdrawal of NRAs' draft measures**

150. Under the terms of Article 7(4) of the framework Directive, there are two specific situations where the Commission has the possibility to require an NRA to withdraw a draft measure which falls within the scope of Article 7(3):

— the draft measure concerns the definition of a relevant market which differs from that identified in the Recommendation, or

— the draft measure concerns a decision as to whether to designate, or not to designate, an undertaking as having SMP, either individually or jointly with others.

151. In respect of the above two situations, where the Commission has indicated to the NRA in the course of the consultation process that it considers that the draft measure would create a barrier to the single European market or where the Commission has serious doubts as to the compatibility of the draft measure with Community law, the adoption of the measure must be delayed by a maximum of an additional two months.

152. During this two-month period, the Commission may, after consulting the Communications Committee following the advisory procedure [126], take a decision requiring the NRA to withdraw the draft measure. The Commission's decision will be accompanied by a detailed and objective analysis of why it considers that the draft measure should not be adopted together with specific proposals for amending the draft measure. If the Commission does not take a decision within that period, the draft measure may be adopted by the NRA.

6.4. **Urgent cases**

153. In exceptional circumstances, NRAs may act urgently in order to safeguard competition and protect the interest of users. An NRA may therefore, exceptionally, adopt proportionate and provisional measures without consulting either interested parties, the NRAs in other Member States, or the Commission. Where an NRA has taken such urgent action, it must, without delay, communicate these measures, with full reasons, to the Commission, and to the other NRAs. The Commission will verify the compatibility of those measures with Community law and in particular will assess their proportionality in relation to the policy objectives of Article 8 of the framework Directive.

154. If the NRA wishes to make the provisional measures permanent, or extends the time for which it is applicable, the NRA must go through the normal consultation procedure set out above. It is difficult to foresee any circumstances that would justify urgent action to define a market or designate an SMP operator, as such measure are not those that can be carried out immediately. The Commission therefore does not expect NRAs to use the exceptional procedures in such cases.

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6.5. **Adoption of the final decision**

155. Once an NRA's decision has become final, NRAs should notify the Commission of the names of the undertakings that have been designated as having SMP and the obligations imposed on them, in accordance with the requirements of Article 36(2) of the universal service Directive and Articles 15(2) and 16(2) of the access Directive. The Commission will thereafter make this information available in a readily accessible form, and will transmit the information to the Communications Committee as appropriate.

156. Likewise, NRAs should publish the names of undertakings that they have designated as having SMP and the obligations imposed on them. They should ensure that up-to-date information is made publicly available in a manner that guarantees all interested parties easy access to that information.

(1) OJ L 108, 24.4.2002, p. 33.

(2) OJ L 108, 24.4.2002, p. 21.

(3) OJ L 108, 24.4.2002, p. 7.

(4) OJ L 108, 24.4.2002, p. 51.

(5) To be adopted.

(6) OJ L 24, 30.1.1998, p. 1.

(7) Except where the new regulatory framework expressly permits obligations to be imposed independently of the competitive state of the market.

(8) Article 14 of the framework Directive.

(9) In addition, transnational markets whose characteristics may be such as to justify sector-specific regulation may be identified by the Commission in a Decision on transnational markets.

(10) Recital 27 of the framework Directive.

(11) Regulation (EEC) No 4064/89 on the control of concentrations between undertakings (OJ L 395, 30.12.1989, p. 1), as last amended by Regulation (EC) No 1310/97 of 30 June 1997 (OJ L 180, 9.7.1997, p. 1) (hereafter the merger control Regulation).

(12) Guidelines on the application of EEC competition rules in the telecommunications sector (OJ C 233, 6.9.1991, p. 2).

(13) Commission notice on the definition of relevant market for the purposes of Community competition law (OJ C 372, 9.12.1997, p. 5).

(14) Notice on the application of the competition rules to access agreements in the telecommunications sector (OJ C 265, 22.8.1998, p. 2).

(15) It is expected that effective cooperation between NRAs and NCAs would prevent the duplication of procedures concerning identical market issues.

(16) Guidelines on the application of EEC competition rules in the telecommunications sector (OJ C 233, 6.9.1991, p. 2).

(17) Article 14(2) of the framework Directive.

(18) Case C-209/98, *Entreprenørforeningens Affalds* [2000] ECR I-3743, paragraph 57, and Case C-242/95 *GT-Link* [1997] ECR I-4449, paragraph 36. It should be recognised that the objective of market definition is not an end in itself, but part of a process, namely assessing the degree of a firm's market power.

(19) See Directive 97/33/EC of the European Parliament and of the Council of 30 June 1997 on interconnection in telecommunications with regard to ensuring universal service and interoperability through application of the principles of open network provision (ONP) (OJ L 199, 26.7.1997, p. 32) (the interconnection Directive); Council Directive 90/387/EEC of 28 June 1990 on the establishment of the internal market for telecommunications services through the implementation of open network provision (OJ L 192, 24.7.1990, p. 1) (the ONP framework Directive); Council Directive 92/44/EEC of 5 June 1992 on the application of open network provision to leased lines (OJ L 165, 19.6.1992, p. 27) (the leased lines Directive); Directive 95/62/EC of the European Parliament and of the Council of 13 December 1995 on the application of open network provision (ONP) to voice telephony (OJ L 321, 30.12.1995, p. 6), replaced by Directive 98/10/EC of the European Parliament and of the Council of 26 February 1998 on the application of open network provision (ONP) to voice telephony and on universal service for telecommunications in a competitive environment (OJ L 101, 1.4.1998, p. 24) (the ONP voice telephony Directive).

(20) Joined Cases C-68/94 and C-30/95, *France and Others* v *Commission* [1998] ECR I-1375. See, also, Notice on market definition, at paragraph 12.

(21) To the extent that the electronic communications sector is technology and innovation-driven, any previous market definition may not necessarily be relevant at a later point in time.

(22) Notice on market definition, paragraph 12.

(23) See, also, Notice on market definition, paragraphs 20-23, Case IV/M.1225 — Enso/Stora, (OJ L 254, 29.9.1999), paragraph 40.

(24) See Notice on market definition, paragraph 24. Distinguishing between supply-side substitution and potential competition in electronic communications markets may be more complicated than in other markets given the dynamic character of the former. What matters, however, is that potential entry from other suppliers is taken into consideration at some stage of the relevant market analysis, that is, either at the initial market definition stage or at the subsequent stage of the assessment of market power (SMP).

(25) It is not necessary that all consumers switch to a competing product; it suffices that enough or sufficient switching takes place so that a relative price increase is not profitable. This requirement corresponds to the principle of 'sufficient interchangeability' laid down in the case-law of the Court of Justice; see below, footnote 32.

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([26]) See, also, Access notice, paragraph 46, and Case T-83/91, *Tetra Pak* v *Commission*, [1994] ECR II-755, paragraph 68. This test is also known as 'SSNIP' (small but significant non transitory increase in price). Although the SSNIP test is but one example of methods used for defining the relevant market and notwithstanding its formal econometric nature, or its margins for errors (the so-called 'cellophane fallacy', see below), its importance lies primarily in its use as a conceptual tool for assessing evidence of competition between different products or services.

([27]) See Notice on market definition, paragraphs 17-18.

([28]) In other words, where the cross-price elasticity of demand between two products is high, one may conclude that consumers view these products as close substitutes. Where consumer choice is influenced by considerations other than price increases, the SSNIP test may not be an adequate measurement of product substitutability; see Case T-25/99, *Colin Arthur Roberts and Valerie Ann Roberts* v *Commission*, [2001] ECR II-1881.

([29]) Within the context of market definition under Article 82 of the EC Treaty, a competition authority or a court would estimate the 'starting price' for applying the SSNIP on the basis of the price charged by the alleged monopolist. Likewise, under the prospective assessment of the effects which a merger may have on competition, the starting price would be based on the prevailing prices of the merging parties. However, where an NRA carries out a market analysis for the purposes of applying Article 14 of the framework Directive the service or product in question may be offered by several firms. In such a case, the starting price should be the industry 'average price'.

([30]) It is worth noting that prices which result from price regulation which does not aim at ensuring that prices are cost-based, but rather at ensuring an affordable offer within the context of the provision of universal services, may not be presumed to be set at a competitive level, nor should they serve as a starting point for applying the SSNIP test.

([31]) Indeed, one of the drawbacks of the application of the SSNIP test is that in some cases, a high-demand cross-price elasticity may mean that a firm has already exercised market power, a situation known in competition law and practice as the 'cellophane fallacy'. In such cases, the prevailing price does not correspond to a competitive price. Determining whether the prevailing price is set above the competitive level is admittedly one of the most difficult aspects of the SSNIP test. NRAs faced with such difficulties could rely on other criteria for assessing demand and supply substitution such as functionality of services, technical characteristics, etc. Clearly, if evidence exist to show that in the past a firm has engaged in anti-competitive behaviour (price-fixing) or has enjoyed market power, then this may serve as an indication that its prices are not under competitive constraint and accordingly are set above the competitive level.

([32]) Case C-333/94 P, *Tetra Pak* v *Commission* [1996] ECR I-5951, paragraph 13, Case 31/80 *L'Oréal* [1980] ECR 3775, paragraph 25, Case 322/81, *Michelin* v *Commission* [1983] ECR 3461, paragraph 37, Case C-62/86, *AkzoChemie* v *Commission* [1991] ECR I-3359, Case T-504/93, *Tiercé Ladbroke* v *Commission* [1997] ECR II-923, paragraph 81, T-65/96, *Kish Glass* v *Commission* [2000] ECR II-1885, paragraph 62, Case C-475/99, *Ambulanz Glöckner and Landkreis Südwestpfalz*, [2001] ECR I-0000, paragraph 33. The test of sufficient substitutability or interchangeability was first laid down by the Court of Justice in Case 6/72, *Europemballage and Continental Can* v *Commission*, [1973] ECR 215, paragraph 32 and Case 85/76, *Hoffmann La-Roche* v *Commission* [1979] ECR 461, paragraph 23.

([33]) Case C-333/94 P, *Tetra Pak* v *Commission* [1996] ECR I-5951, paragraph 13, Case 66/86, *Ahmed Saeed* [1989] ECR 803, paragraphs 39 and 40, Case *United Brands* v *Commission* [1978] ECR 207, paragraphs 22 and 29, and 12; Case T-229/94, *Deutsche Bahn* v *Commission* [1997] ECR II-1689, paragraph 54. In *Tetra Pak*, the Court confirmed that the fact that demand for aseptic and non-aseptic cartons used for packaging fruit juice was marginal and stable over time relative to the demand for cartons used for packaging milk was evidence of a very little interchangeability between the milk and the non-milk packaging sector, idem, paragraphs 13 and 15.

([34]) For example, in the case of a relative price increase, consumers of a lower quality/price service may switch to a higher quality/price service if the cost of doing so (the premium paid) is offset by the price increase. Conversely, consumers of a higher quality product may no longer accept a higher premium and switch to a lower quality service. In such cases, low and high quality products would appear to be effective substitutes.

([35]) Communication from the Commission — Status of voice on the Internet under Community law, and in particular, under Directive 90/388/EEC — Supplement to the Communication by the Commission to the European Parliament and the Council on the status and implementation of Directive 90/388/EEC on competition in the markets for telecommunications services (OJ C 369, 22.12.2000, p. 3). Likewise, it cannot be excluded that in the future. xDSL technology and multipoint video distribution services based on wireless local loops may be used for the transmission of TV materials in direct competition with other existing TV delivery systems based on cable systems, direct-to-home satellite transmission and terrestrial analogue or digital transmission platforms.

([36]) Switching costs which stem from strategic choices by undertakings rather than from exogenous factors should be considered, together with some other form of entry barriers, at the subsequent stage of SMP assessment. Where a market is still growing, total switching costs for already 'captured' consumers may not be significant and may not thus deter demand or supply-side substitution.

([37]) The time frame to be used to assess the likely responses of other suppliers in case of a relative price increase will inevitably depend on the characteristics of each market and should be decided on a case-by-case basis.

([38]) See, also, Case C-333/94, *Tetra Pak* v *Commission*, op. cit., paragraph 19. As mentioned above, the required investments should also be undertaken within a reasonable time frame.

([39]) See, also, Case COMP/M.2574 — Pirelli/Edizione/Olivetti/Telecom Italia, paragraph 58.

([40]) *United Brands*, op. cit., paragraph 44, *Michelin*, op. cit., paragraph 26, Case 247/86 *Alsatel* v *Novasam* [1988] ECR 5987, paragraph 15; *Tiercé Ladbroke* v *Commission*, op. cit., paragraph 102.

([41]) *Deutsche Bahn* v *Commission*, op. cit., paragraph 92. Case T-139/98 *AAMS* v *Commission*, [2001] ECR 0000-II, paragraph 39.

([42]) See, for instance, Case IV/M.1025 — Mannesmann/Olivetti/Infostrada, paragraph 17, and Case COMP/JV.23 — Telefónica Portugal Telecom/Médi Telecom.

([43]) In practice, this area will correspond to the limits of the area in which an operator is authorised to operate. In Case COMP/M.1650 — ACEA/Telefónica, the Commission pointed out that since the notified joint venture would have a licence limited to the area of Rome, the geographical market could be defined as local; at paragraph 16.

[44] The fact that mobile operators can provide services only in the areas where they have been authorised to and the fact that a network architecture reflects the geographical dimension of the mobile licences explains why mobile markets are considered to be national in scope. The extra connection and communications costs that consumers face when roaming abroad, coupled with the loss of certain additional service functionalities (i.e. lack of voice mail abroad) further supports this definition; see Case IV/M.1439 — Telia/Telenor, paragraph 124, Case IV/M.1430 — Vodafone/Airtouch, paragraphs 13-17, Case COMP/JV.17 — Mannesmann/Bell Atlantic/Omnitel, paragraph 15.

[45] Physical interconnection agreements may also be taken into consideration for defining the geographical scope of the market, Case IV/M.570 — TBT/BT/TeleDanmark/Telenor, paragraph 35.

[46] Case IV/M.856 — British Telecom/MCI (II), paragraph 19s., Case IV/JV.15 — BT/AT & T, paragraph 84 and 92, Case COMP/M.2257 — France Telecom/Equant, paragraph 32, It is highly unlikely that the provision of electronic communications services could be segmented on the basis of national (or local) bilateral routes.

[47] Reference may be made, for instance, to the market for backhaul capacity in international routes (i.e. cable station serving country A to country E) where a potential for substitution between cable stations serving different countries (i.e., cable stations connecting Country A to B, A to C and A to D) may exist where a supplier of backhaul capacity in relation to the route A to E is or would be constrained by the ability of consumers to switch to any of the other 'routes', also able to deal with traffic from or to country E.

[48] Where a market is defined on the basis of a bilateral route, its geographical scope could be wider than national if suppliers are present in both ends of the market and can satisfy demand coming from both ends of the relevant route.

[49] See Notice on market definition, paragraphs 57 and 58. For instance, chain substitutability could occur where an undertaking providing services at national level constraints the prices charged by undertakings providing services in separate geographical markets. This may be the case where the prices charged by undertakings providing cable networks in particular areas are constrained by a dominant undertaking operating nationally; see also, Case COMP/M.1628 — TotalFina/Elf (OJ L 143, 29.5.2001, p. 1), paragraph 188.

[50] Evidence should show clear price interdependence at the extremes of the chain and the degree of substitutability between the relevant products or geographical areas should be sufficiently strong.

[51] The Commission has, *inter alia*, made references in its decisions to the existence of the following markets: international voice-telephony services (Case IV/M.856 — British Telecommunications/MCI (II), OJ L 336, 8.12.1997), advanced telecommunications services to corporate users (Case IV/35.337, Atlas, OJ L 239, 19.9.1996, paragraphs 5-7, Case IV/35617, Phoenix/Global/One, OJ L 239, 19.9.1996, paragraph 6, Case IV/34.857, BT-MCI (I), OJ L 223, 27.8.1994), standardised low-level packet-switched data-communications services, resale of international transmission capacity (Case IV/M.975 — Albacom/BT/ENI, paragraph 24) audioconferencing (Albacom/BT/ENI, paragraph 17), satellite services (Case IV/350518 — Iridium, OJ L 16, 18.1.1997), (enhanced) global telecommunications services (Case IV/JV.15 — BT/AT & T, Case COMP/M.1741 — MCI WorldCom/Sprint, paragraph 84, Case COMP/M.2257 — France Telecom/Equant, paragraph 18), directory-assistance services (Case IV/M.2468 — SEAT Pagine Gialle/ENIRO, paragraph 19, Case COMP/M.1957 — VIAG Interkom/Telenor Media, paragraph 8), Internet-access services to end users (Case IV/M.1439 — Telia/Telenor, Case COMP/JV.46 — Blackstone/CDPQ/Kabel Nordrhein/Westfalen, paragraph 26, Case COMP/M.1838 — BT/Esat, paragraph 7), top-level or universal Internet connectivity (Case COMP/M.1741 — MCI WorldCom/Sprint, paragraph 52), seamless pan-European mobile telecommunications services to internationally mobile customers (Case COMP/M.1975 — Vodafone Airtouch/ Mannesmann, Case COMP/M.2016 — France Telecom/Orange, paragraph 15), wholesale roaming services (Case COMP/M.1863 — Vodafone/ Airtel, paragraph 17), and market for connectivity to the international signalling network (Case COMP/2598 — TDC/CMG/Migway JV, paragraphs 17-18).

[52] See, also, Joined Cases T-125/97 and T-127/97, *The Coca-Cola Company and Others* v *Commission* [2000] ECR II-1733, at paragraphs 81 and 82.

[53] See, also, Article 15 of the framework Directive.

[54] Access notice, paragraph 45.

[55] See Case COMP/M.1439 — Telia/Telenor.

[56] See Telia/Telenor, BT/AT & T, France Télécom/Equant, op. cit. See also Commission Decision of 20 May 1999, Cégétel + 4 (OJ L 218, 18.8.1999), paragraph 22. With regard to the emerging market for 'Global broadband data communications services — GBDS', the Commission has found that such services can be supported by three main network architectures: (i) terrestrial wireline systems; (ii) terrestrial wireless systems; and (iii) satellite-based systems, and that from a demand side, satellite-based GBDS can be considered as a separate market, Case COMP/M.1564 — Astrolink, paragraphs 20-23.

[57] Directive 96/19/EC, recital 20 (OJ L 74, 22.3.1996, p. 13). See, also, communication from the Commission, 'Unbundled access to the local loop: enabling the competitive provision of a full range of electronic communication services, including broadband multimedia and high speed Internet' (OJ C 272, 23.9.2000, p. 55). Pursuant to point 3.2, 'While categories of services have to be monitored closely, particularly given the speed of technological change, and regularly reassessed on a case-by-case basis, these services are presently normally not substitutable for one another, and would therefore be considered as forming different relevant markets'.

[58] The Commission has identified separate markets for services to large multinational corporations (MNCs) given the significant differences in the demand (and supply) of services to this group of customers compared to other retail (business) customers, see Case IV/JV.15 — BT/AT & T, Case COMP/M.1741 — MCI WorldCom/Sprint, Case COMP/M.2257 — France Télécom/Equant.

[59] See communication on 'Unbundled access to the local loop', op.cit, point 3.2. The market for 'high-speed' communications services could possibly be further divided into distinct segments depending on the nature of the services offered (i.e. Internet services, video-on-demand, etc.).

[60] Case COMP/M.2574 — Pirelli/Edizione/Olivetti/Telecom Italia, paragraph 33. It could also be argued that dial-up access to the Internet via existing 2G mobile telephones is a separate market from dial-up access via the public switched telecommunications network. According to the Commission, accessing the Internet via a mobile phone is unlikely to be a substitute for existing methods of accessing the Internet via a PC due to difference in sizes of the screen and the format of the material that can be obtained through the different platforms; see Case COMP/M.1982 — Telia/Oracle/Drutt, paragraph 15, and Case COMP/JV.48 Vodafone/Vivendi/Canal+.

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([61]) Case COMP/M.2469 — Vodafone/Airtel, paragraph 7, Case IV/M.1430 — Vodafone/Airtouch, Case IV/M.1669, Deutsche Telecom/One2One, paragraph 7. Whether this market can be further segmented into a carrier (network operator) market and a downstream service market should be decided on a case-by-case basis; see Case IV/M.1760 — Mannesmann/Orange, paragraphs 8-10, and Case COMP/M.2053 — Telenor/BellSouth/Sonofon, paragraphs 9-10.

([62]) For instance, in British Interactive Broadcasting/Open, the Commission noted that for the provision of basic voice services to consumers, the relevant infrastructure market included not only the traditional copper network of BT but also the cable networks of the cable operators, which were capable of providing basic telephony services, and possibly wireless fixed networks, Case IV/36.359, (OJ L 312, 6.12.1999, paragraphs 33-38). In Case IV/M.1113 — Nortel/Norweb, the Commission recognised that electricity networks using 'digital power line' technology could provide an alternative to existing traditional local telecommunications access loop, paragraphs 28-29.

([63]) In assessing the conditions of network competition in the Irish market that would ensue following full liberalisation, the Commission also relied on the existence of what, at that period of time, were perceived as potential alternative infrastructure providers, namely, cable TV and electricity networks, Telecom Eireann, cit., paragraph 30. The Commission left open the question whether the provision of transmission capacity by an undersea network infrastructure constitutes a distinct market from terrestrial or satellite transmissions networks, Case COMP/M.1926 — Telefonica/Tyco/JV, at paragraph 8.

([64]) Case COMP/M.1439, Telia/Telenor, paragraph 79. For instance, an emerging pan-European market for wholesale access (SMS) to mobile infrastructure has been identified by the Commission in Case COMP/2598 — TDC/CMG/Migway JV, at paragraphs 28-29.

([65]) In applying these criteria, the Commission has found that, as far as the fixed infrastructure is concerned, demand for the lease of transmission capacity and the provision of related services to other operators occurs at wholesale level (the market for carrier's carrier services; see Case IV/M.683 — GTS-Hermes Inc./HIT Rail BV, paragraph 14, Case IV/M.1069 — WorldCom/MCI (OJ L 116, 4.5.1999, p. 1), Unisource (OJ L 318, 20.11.1997, p. 1), Phoenix/Global One (OJ L 239, 19.9.1996, p. 57), Case IV/JV.2 — Enel/FT/DT. In Case COMP/M.1439 — Telia/Telenor, the Commission identified distinct patterns of demand for wholesale and retail (subscriber) access to network infrastructure (provision or access to the local loop, and provision or access to long distance and international network infrastructure), paragraphs 75-83.

([66]) See footnote 58.

([67]) Fibre optics are currently competitive only on upstream transmission markets whereas wireless local loops which are still to be deployed will target mainly professionals and individuals with particular communications needs. With the exception of certain national markets, existing cable TV networks need costly upgrades to support two ways broadband communications, and, compared with xDLS technologies, they do not offer a guaranteed bandwidth since customers share the same cable channel.

([68]) See also Case IV/JV.11 — @Home Benelux BV.

([69]) For example, if a fixed operator wants to terminate calls to the subscribers of a particular network, in principle, it will have no other choice but to call or interconnect with the network to which the called party has subscribed. For instance, in light of the 'calling party pays' principle, mobile operators have no incentives to compete on prices for terminating traffic to their own network. See also, OECD, 'Competition issues in telecommunications-background note for the secretariat', DAFFE/CLP/WP2(2001)3, and Commission's press release IP/02/483.

([70]) Case 27/76 *United Brands* v *Commission* [1978] ECR 207.

([71]) See, also, recital 25 of the framework Directive.

([72]) See Article 14, paragraph 2, and recital 28 of the framework Directive.

([73]) It should be noted that NRAs do not have to find an abuse of a dominant position in order to designate an undertaking as having SMP.

([74]) Case 85/76, *Hoffmann-La Roche* v *Commission* [1979] ECR 461, paragraph 39. It should be stressed here that for the purposes of *ex-ante* regulation, if an undertaking has already been imposed regulatory obligations, the fact that competition may have been restored in the relevant market as a result precisely of the obligations thus imposed, this does not mean that that undertaking is no longer in a dominant position and that it should no longer continue being designated as having SMP.

([75]) The absence of any substitutable service or product may justify a finding of a situation of economic dependence which is characteristic of the existence of a dominant position. See Commission decisions, Decca Navigator System (OJ L 43, 15.2.1987, p. 27) and Magill TV Guide: ITP, BBC, RTE (OJ L 78, 21.3.1989, p. 43). See also, Case 22/78 *Hugin* v *Commission* 1979 [ECR] 1869, Case 226/84, *British Leyland* v *Commission* 1986 [ECR] p. 3263.

([76]) See, also, recital 15 of Council Regulation (EEC) No 4064/89.

([77]) *United Brands* v *Commission*, op. cit. The greater the difference between the market share of the undertaking in question and that of its competitors, the more likely will it be that the said undertaking is in a dominant position. For instance, in Case COMP/M.1741 — MCI WorldCom/Sprint it was found that the merged entity would have in the market for the provision of top-level Internet connectivity an absolute combined market share of more than [35-45] %, several times larger than its closest competitor, enabling it to behave independently of its competitors and customers (see paragraphs 114, 123, 126, 146, 155 and 196).

([78]) Case C-62/86, *AKZO* v *Commission*, [1991] ECR I-3359, paragraph 60; Case T-228/97, *Irish Sugar* v *Commission*, [1999] ECR II-2969, paragraph 70, Case *Hoffmann-La Roche* v *Commission*, op. cit, paragraph 41, Case T-139/98, *AAMS and Others* v *Commission* [2001 ECR II-0000, paragraph 51. However, large market shares can become accurate measurements only on the assumption that competitors are unable to expand their output by sufficient volume to meet the shifting demand resulting from a rival's price increase.

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(79) Case *Hoffmann-La Roche* v *Commission*, op. cit., paragraph 41, Case C-62/86, *Akzo* v *Commission* [1991] ECR I-3359, paragraphs 56, 59. 'An undertaking which has a very large market share and holds it for some time, by means of the volume of production and the sale of the supply which it stands for — without holders of much smaller market shares being able to meet rapidly the demand from those who would like to break away from the undertaking which has largest market share — is by virtue of that share in a position of strength which makes it an unavoidable trading partner and which, because of this alone, secures for it, at the very least during relatively long periods, that freedom of action which is the special feature of a dominant position', Case *AAMS and Others* v *Commission*, op. cit., paragraph 51.

(80) Notice on market definition, op. cit., at p. 5.

(81) See Case COMP/M.1741 — MCI WorldCom/Sprint, paragraph 239-240. In bidding markets, however, it is important not to rely only on market shares as they in themselves may not be representative of the undertakings actual position, for further discussion, see, also, Case COMP/M.2201 — MAN/Aüwarter.

(82) See, Determination of organisations with significant power (SMP) for the implementation of the ONP Directive, DG XIII, 1 March 1999, at http://europa.eu.int/ISPO/infosoc/telecompolicy/en/SMPdeter.pdf, at paragraph 3.2.

(83) Idem, at paragraph 5.2.

(84) With regard to the interconnection market of fixed and mobile networks, the termination traffic to be measured should include own network traffic and interconnection traffic received from all other fixed and mobile networks, national or international.

(85) *Hoffmann-La Roche* v *Commission*, op. cit., at paragraph 48. One of the most important types of entry barriers is sunk costs. Sunk costs are particularly relevant to the electronic communications sector in view of the fact that large investments are necessary to create, for instance, an efficient electronic communications network for the provision of access services and it is likely that little could be recovered if a new entrant decides to exit the market. Entry barriers are exacerbated by further economies of scope and density which generally characterise such networks. Thus, a large network is always likely to have lower costs than a smaller one, with the result that an entrant in order to take a large share of the market and be able to compete would have to price below the incumbent, making it thus difficult to recover sunk costs.

(86) Joined Cases C-241/91 P and C-242/91 P, *RTE and ITP* v *Commission*, [1995] ECR I-743, Case C-7/97, *Oscar Bronner* [1998] ECR I-7791, and Joined Cases T-374/94, T-375/94, T-384/94 and T-388/94, *European Night Services and others* v *Commission* [1998] ECR II-3141.

(87) Case COMP/M.1741 — MCI WorldCom/Sprint, paragraph 196.

(88) Case C-333/94 P, *Tetra Pak* v *Commission* [1996] ECR I-5951.

(89) See, also, Case COMP/M.2146 — Tetra Laval/Sidel, paragraphs 325-389, *sub judice*, T-5/02.

(90) See Access notice, paragraph 65.

(91) In the case of horizontal markets, the market analysis should focus on establishing the existence of close associative links which will enable an undertaking dominant in one market to behave independently of its competitors in a neighbouring market. Such links may be found to exist by reference to the type of conduct of suppliers and users in the markets under consideration (same customers and/or suppliers in both markets, i.e. customers buying both retail voice calls and retail Internet access) or the fact that the input product or service is essentially the same (i.e. provision by a fixed operator of network infrastructure to ISPs for wholesale call origination and wholesale call termination); see, also, Case T-83/91, *Tetra Pak* v *Commission*, op. cit., paragraph 120 and Case COMP/M.2416 — *Tetra Laval/Sidel*.

(92) Article 14(3) of the framework Directive is not intended to apply in relation to market power leveraged from a 'regulated' market into an emerging, 'non-regulated' market. In such cases, any abusive conduct in the 'emerging' market would normally be dealt with under Article 82 of the EC Treaty.

(93) See Access notice, paragraph 79.

(94) Joined cases C-395/96 P and C-396/96 P, *Compagnie maritime belge and others* v *Commission* [2000] ECR I-1365.

(95) Idem, at paragraph 39.

(96) Case T102/96, *Gencor* v *Commission* [1999] ECR II-753.

(97) See Joined Cases T-68/89, T-77/89 and T-78/89, *SIV and Others* v *Commission* [1992] ECR II-1403, paragraph 358, Case C-393/92 *Almelo* [1994] ECR I-1477, paragraph 43, Case C-96/94, *Centro Servizi Spediporto* [1995] ECR I-2883, paragraph 33, Joined Cases C-140/94, 141/94, and C-142/94, *DIP*, [1995] ECR I-3257, paragraph 62, Case C-70/95, *Sodemare* [1997] ECR I-3395, paragraph 46, and Joined Cases C-68/94 and C-30/95 *France and Others* v *Commission* [1998] ECR I-1375, paragraph 221.

(98) Case IV/M.619 — Gencor Lonhro (OJ L 11, 14.1.1997, p. 30).

(99) *Gencor* v *Commission*, op. cit., at paragraph 276.

(100) Idem, at paragraph 277.

(101) *Compagnie maritime belge transports and Others*, op. cit., at paragraph 39, see, also, Case T-342/99 *Airtours/Commission* [2002] ECR II-0000, paragraph 76.

(102) See, in particular, *France and Others* v *Commission*, op. cit., paragraph 221.

(103) Compagnie maritime belge, at paragraph 39.

(104) Idem at paragraph 44.

(105) Idem at paragraph 45.

(106) The use here of the term 'coordinated effects' is no different from the term 'parallel anticompetitive behaviour' also used in Commission's decisions applying the concept of collective (oligopolistic) dominance.

([107]) See in particular, Cases COMP/M.2498 — UPM-Kymmene/Haindl, and COMP/M.2499 — Norske Skog/Parenco/Walsum, Case COMP/M.2201 — MAN/Auwärter, Case COMP/M.2097 — SCA/Matsä Tissue, Case COMP/M.1882 — Pirelli/BICC, Case COMP/M.1741 — MCI WorldCom/Sprint, *sub judice*, T-310/00 Case IV/M.1524 — Airtours/First Choice (OJ L 93, 13.4.2000, p. 1), *sub judice* T-342/99, Case IV/M.1383 — Exxon/Mobil, Case IV/M.1313 — Danish Crown/Vestjyske Slagterier (OJ L 20, 25.1.2000, p. 1), Case IV/M.1225 — Enso/Stora (OJ L 254, 29.9.1999, p. 9), Case IV/M.1016 — Price Waterhouse/Coopers & Lybrand (OJ L 50, 26.2.1999, p. 27), Case IV/M.619 — Gencor/Lonrho, cit., Case IV/M.308, Kali + Salz/MdK/Treuhand (OJ L 186, 21.7.1994, p. 38) and Case IV/M.190 — Nestlé/Perrier (OJ L 356, 5.12.1992, p. 1).

([108]) This is in essence the type of analysis carried out by the Commission in past decisions related to collective dominance, see, for instance, Case IV/M.190 — Nestlé/Perrier, (OJ L 356, 5.12.1992, p. 1), Gencor/Lonrho, cit., Case IV/M.1383 — Exxon/Mobil, paragraph 259, Case IV/M.1524 — Airtours/First Choice (OJ L 93, 13.4.2000, p. 1), and Case COMP/M.2499 — Norske Skog/Parenco/Walsum, paragraph 76; see, also, *Airtours* v *Commission*, op. cit., paragraph 62.

([109]) See, also, recital 26 of the framework Directive: 'two or more undertakings can be found to enjoy a joint dominant position not only where there exist structural or other links between them but also where the structure of the relevant market is conducive to coordinated effects, that is, it encourages parallel or aligned anticompetitive behaviour on the market'.

([110]) See Case COMP/M.2498 — UPM-Kymmene/Haindl, and Case COMP/M.2499 — Norske Skog/Parenco/Walsum, at paragraph 77.

([111]) See, for instance, Case COMP/M.2097 — SCA/Metsä Tissue.

([112]) For instance, in Case COMP/M.2201 — MAN/Auwärter, despite the fact that two of the parties present in the German city-bus market in Germany, MAN/Auwärter and EvoBus, would each supply just under half of that market, the Commission concluded that there was no risk of joint dominance. In particular, the Commission found that any tacit division of the market between EvoBus and MAN/Auwärter was not likely as there would be no viable coordination mechanism. Secondly, significant disparities between EvoBus and MAN/Auwärter, such as different cost structures, would make it likely that the companies would compete rather than collude. Likewise, in the Alcoa/British Aluminium case, the Commission found that despite the fact that two of the parties present in the relevant market accounted for almost 80 % of the sales, the market could not be said to be conducive to oligopolistic dominance since (i) market shares were volatile and unstable; and (ii) demand was quite irregular making it difficult for the parties to be able to respond to each other's action in order to tacitly coordinate their behaviour. Furthermore, the market was not transparent in relation to prices and purchasers had significant countervailing power. The Commission's conclusions were further reinforced by the absence of any credible retaliation mechanism likely to sustain any tacit coordination and the fact that competition in the market was not only based on prices but depended to a large extent on technological innovation and after-sales follow-up, Case COMP/M.2111 — Alcoa/British Aluminium.

([113]) Likewise, in Case COMP/M.2348 — Outokumpu/Norzink, the Commission found that even if the zinc market was composed of few players, entry barriers were high and demand growth perspectives low, the likelihood of the emergence of a market structure conducive to coordinated outcome was unlikely if it could be shown that (i) parties could not manipulate the formation of prices; (ii) producers had asymmetric cost structures and there was no credible retaliation mechanism in place.

([114]) See Case COMP/M.1741 — MCI WorldCom/Sprint, paragraph 263.

([115]) Idem, paragraphs 257-302.

([116]) Case COMP/M.1838 — BT/Esat.

([117]) Idem, paragraphs 10 to 14.

([118]) Case IV/M.1430 — Vodafone/Airtouch.

([119]) Idem, at paragraph 28. The likely emergence of a duopolistic market concerned only the three largest mobile operators, that is D2 and E-Plus, on the one hand, and T-Mobil on the other hand, given that VIAG Interkom's market share was below 5 %. The Commission's concerns were finally removed after the parties proposed to divest Vodafone's entire stake in E-Plus.

([120]) Case COMP/M.2016 — France Telecom/Orange, at paragraph 26.

([121]) Idem, at paragraphs 39-40. In its working document 'On the initial findings of the sector inquiry into mobile roaming charges', the Commission made reference to (i) the likely existence of a number of economic links between mobile operators, namely through their interconnection agreements, their membership of the GSM Association, the WAP and the UMTS forum, the fact that terms and conditions of roaming agreements were almost standardised; and (ii) the likely existence of high barriers to entry. In its preliminary assessment the Commission also stressed that the fact that the mobile market is, in general, technology driven, did not seem to have affected the conditions of competition prevailing on the wholesale international roaming market, see: http://europa.eu.int/comm/competition/antitrust/others/sector_inquiries/roaming/, at pages. 24 and 25.

([122]) GATS commitments taken by EC on telecommunications: http://gats-info.eu.int/gats-info/swtosvc.pl?&SECCODE=02.C.

([123]) The Communications Committee in Article 22 of the framework Directive also aims at ensuring effective cooperation between the Commission and the Member States.

([124]) The specific Articles covered are as follows: Articles 15 and 16 of the framework Directive (the latter of which refers to Articles 16-19 of the universal service Directive and Articles 7 and 8 of the access Directive), Articles 5 and 8 of the access Directive (the latter of which refers to the obligations provided for in Articles 9-13 of the access Directive) and Article 16 of the universal service Directive (which refers to Articles 17-19 of universal service Directive). In addition, Article 6 of the access Directive, although not explicitly referenced in Article 7 of the framework Directive, itself contains cross-reference to Article 7 of the framework Directive and is therefore covered by the procedures therein.

([125]) Recital 38 of the framework Directive.

([126]) As provided for in Article 3 of Council Decision 1999/468/EC laying the procedure for the exercising of implementing powers conferred on the Commission, the Commission shall take the utmost account of the opinion delivered by the Committee, but shall not be bound by the opinion.

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MALAYSIAN COMMUNICATIONS AND MULTIMEDIA COMMISSION

GUIDELINE ON SUBSTANTIAL LESSENING OF COMPETITION

RG/SLC/1/00(1)

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Competition Guidelines

Pursuant to section 134 and section 138 of the Communications and Multimedia Act 1998 (the CMA), the Malaysian Communications & Multimedia Commission has published Guidelines on "Dominant Position in a Communications Market" and "Substantial Lessening of Competition in a Communications Market".

These Guidelines went through a fifty day public consultation process commencing on 12 August 1999, whereby the public was invited to give their comments on the draft Guidelines. The draft Guidelines were made available in hard copy as well as on the Commission's website.

A total of five written submissions were received from the following parties - Telekom Malaysia Berhad, Zaid Ibrahim & Co, Maxis Communications Bhd & DiGi Telecommunications Sdn Bhd (joint submission), TIME Telecommunications Sdn Bhd and AIMS Sdn Bhd (via email).

The responses received proved insightful and useful and the Commission appreciates the effort made and interest shown by the respondents.

It is the Commission's intention to update these Guidelines from time to time following appropriate consultation with industry, and taking into account developments in the communications and multimedia sector as well as the Commission's experience in enforcing the CMA.

GUIDELINE ON SUBSTANTIAL LESSENING OF COMPETITION

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GUIDELINE:
SUBSTANTIAL LESSENING OF COMPETITION IN A COMMUNICATIONS MARKET

1. Objective

The Malaysian Communications and Multimedia Commission ("the Commission") has prepared this guideline in order to clarify how it will apply the test of "substantial lessening of competition" to a licensee in a communications market for the purposes of administering the *Communications and Multimedia Act 1998* ("the Act"). This guideline should be read in conjunction with the guideline published by the Commission concerning market dominance.

2. Introduction

2.1 Section 134 of the *Communications and Multimedia Act 1998* ("the Act") states that the Commission may publish guidelines which clarify the meaning of "substantial lessening of competition". This document is the first such written clarification of the concept of "substantial lessening of competition" issued by the Commission.

2.2 This guideline sets out the considerations which will usually guide the Commission in any decision to take legal action against conduct by a licensee. The intention of the guideline is to provide insight into the Commission's approach to the enforcement of sections 133 and 139, the kinds of conduct which the Commission may be compelled to act against, and the considerations which will be relevant when considering whether to authorise conduct under section 140.

2.3 Section 134 of the Act states:-

*"**134.** (1) The Commission may publish guidelines which clarify the meaning of 'substantial lessening of competition'.*

(2) The guidelines may include reference to -

(a) the relevant economic market;

(b) global trends in the relevant market;

(c) the impact of the conduct on the number of competitors in the market and their market shares;

(d) the impact of the conduct on barriers to entry into the market;

(e) the impact of the conduct on the range of services in the market;

(f) the impact of the conduct on the cost and profit structures in the market; and

(g) any other matters that the Commission is satisfied are relevant."

2.4 Section 134 does not require the Commission to present an exhaustive or definitive list of the factors which it will consider relevant, or of the approaches it will adopt in forming a view whether a substantial lessening of competition has occurred. In considering issues related to lessening of competition, the Commission will form a view in good faith and on reasonable grounds. The Commission will have regard to this guideline, but will not be limited by it if the Commission forms the view that other factors may also be relevant to decisions that it is required to make.

3. Legislative Context

3.1 The concept of "substantially lessening competition" is fundamental to the economic regulation of the communications industry. The concept arises in four contexts in the Act. Each of these contexts requires the Commission to make an assessment of whether conduct has had, is having, or will have, the purpose or effect of substantially lessening competition in a communications market:-

a. Conduct by a licensee in a communications market which has the purpose of substantially lessening competition is expressly forbidden under section 133 of the Act.

   In this case, the Commission may seek interim or interlocutory injunctions under section 142 or seek the imposition of fines under section 143 against a licensee engaging in any conduct prohibited under section 133. This requires the Commission to be satisfied that conduct has been engaged in with the purpose of substantially lessening competition in a communications market. Moreover, the Commission may direct a licensee under section 51 to cease such conduct to the extent that a contravention of section 133 is a breach of licence condition.

b. Under section 139, the Commission may direct a licensee in a dominant position in a communications market to cease a conduct which has or may have the effect of substantially lessening competition. This requires the Commission to be satisfied that there is such an effect.

c. The Commission may authorise conduct under section 140 which might otherwise be forbidden under sections 133 or 139, if it is satisfied that the conduct is in the national interest.

   This will normally require the Commission to be satisfied that the national interest in the conduct outweighs the possible negative effects (if any) of substantially lessening competition in a communications market.

d. The Minister may make rules under section 144 intended to prevent or mitigate conduct by foreign network facilities providers and/or foreign

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network service providers which will or is likely to lead to a substantial lessening of competition in a communications market. The Commission is responsible for the enforcement of these rules.

3.2 The Commission recognises that the concept of "substantially lessening competition" is new in the Malaysian context. Nevertheless, the concept has antecedents in other jurisdictions which may provide useful guidance.

4. Policy Context

4.1 The Act is designed to achieve certain policy objects which are set out in section 3. The Commission must have regard to these objects in the implementation of the Act. Section 3 states:-

*"**3.** (1) The objects of this Act are -*

(a) to promote national policy objectives for the communications and multimedia industry;

(b) to establish a licensing and regulatory framework in support of national policy objectives for the communications and multimedia industry;

(c) to establish the powers and functions of the Malaysian Communications and Multimedia Commission; and

(d) to establish powers and procedures for the administration of this Act.

(2) The national policy objectives for the communications and multimedia industry are -

(a) to establish Malaysia as a major global centre and hub for communications and multimedia information and content services;

(b) to promote a civil society where information-based services will provide the basis of continuing enhancements to quality or work and life;

(c) to grow and nurture local information resources and cultural representation that facilitate the national identity and global diversity;

(d) to regulate for the long-term benefit of the end user;

(e) to promote a high level of consumer confidence in service delivery from the industry;

(f) to ensure an equitable provision of affordable services over ubiquitous national infrastructure;

(g) to create a robust applications environment for end users;

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(h) to facilitate the efficient allocation of resources such as skilled labour, capital, knowledge and national assets;

(i) to promote the development of capabilities and skills within Malaysia's convergence industries; and

(j) to ensure information security and network reliability and integrity".

4.2 The Explanatory Statement to the Bill sets out specific objectives for the economic regulation in Part VI. These objectives explicitly link the prohibitions of Part VI to the implementation of the objects of the Act, including the national policy objectives for the development of the communications and multimedia industry. These objectives are:-

- to promote consumer markets which offer choice, quality and affordability;
- to promote any-to-any connectivity for network services used for communications between end users;
- to promote competition in all communications markets; and
- to promote investment and innovation in network facilities, network services and applications services, and their efficient utilisation.

4.3 In addition, the Explanatory Statement also sets out a number of goals for the administration of Chapter 2 of Part VI, including sections 133, 139 and 140. These goals are:-

- to provide protection for smaller operators in the absence of a general competitive policy or trade practices regulatory regime;
- to provide a context for, and certainty about, the manner in which the general powers and procedures under the Act should be administered. This reinforces the regulatory intent of the national policy for the development of the communications and multimedia sector;
- to establish a framework and clear powers for the Commission to ensure that anti-competitive practices do not undermine the national policy.

4.4 The establishment and maintenance of competitive communications markets is closely related to many of these objectives. Competition of itself promotes several kinds of efficiency which are directly related to the objects of the Act such as technical or productive efficiency, allocative efficiency and dynamic efficiency. It is therefore a powerful instrument to improve industry performance.

5. Implications of Policy Objectives

5.1 The objects of the Act have different significance for sections 133, 139 and 140. These are addressed in turn.

5.2 The section 133 prohibition of conduct with the purpose of substantially lessening competition is clear and unqualified.

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5.3 The objects of the Act nevertheless play an important role in the enforcement of section 133. The Commission's view of what constitutes conduct which is intended to "substantially" lessen competition will be based on the objects of the Act, including the national policy objectives. Decisions regarding action under section 133 will be considered in the light of the impact of licensee conduct on the achievement of these policy objectives. To put it another way, the Commission will make an assessment of the likely outcome of the conduct, make an assessment of the likely outcome in the absence of the conduct, and make a judgement on whether the difference can be called "substantial".

5.4 A different approach will be adopted in relation to sections 139 and 140. Section 139 provides that the Commission may direct a licensee in a dominant position, but leaves the Commission a wide discretion subject only to the objects of the Act and any relevant Ministerial directions. Section 140 requires the Commission to make an assessment of the "national interest" when deciding whether to authorise conduct which might otherwise be regarded as in breach of the Act, particularly of section 133 or section 139, but provides no guidance on how to define the national interest.

5.5 The view of the Commission is that the national policy objectives provide the best guide for action in these contexts. In other words, the Commission will use the national policy objectives as the criteria for deciding whether a particular conduct should be subject to direction (in the case of section 139) or is in the national interest (in the case of section 140).

5.6 In contrast to the approach to section 133, this approach to sections 139 and 140 clearly contemplates the possibility that the objective of promoting competition may be traded off against other objectives. The Commission's view is that this would only be justified when the benefits of such a course clearly outweigh the direct and attendant benefits of competition which would otherwise ensue.

5.7 The Minister's rule-making power under section 144 requires the Minister to make a judgement about whether certain types of conduct will or are likely to lead to a substantial lessening of competition in a communications market. The Commission's role is to enforce that judgement after it has been embodied in the rules, not to make the judgement as such. Nevertheless, the Commission believes that this guideline will provide a useful input to the Minister's deliberations on rule-making for international markets.

6. Conduct, Purpose, and Effect

The concept of "substantially lessening competition" occurs in the context of considerations of conduct, and its purpose and effect. For this reason, this section addresses the issues surrounding "conduct", "purpose", and "effect" as used in the legislation. These concepts form an important part of the framework within which the concept of substantially lessening competition" is located and gains much of its relevance.

6.1 "Conduct"

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a. Conduct in its broadest sense encompasses any or all commercial activity in which a licensee could engage. This includes, but is not limited to:-

- decisions to supply or not supply certain goods or services;
- decisions on price setting;
- decisions on the quality of goods or services offered;
- either making or giving effect to an agreement or understanding, written or otherwise;
- requiring others to make or give effect to an agreement or understanding, written or otherwise; and
- making known that an agreement or understanding, written or otherwise, is sought.

b. For the purposes of this guideline, the Commission's view is that the relevant "conduct" means any action, or a lack of action, which can either actually or potentially affect the level of competition in a market. That is, the Commission is concerned with kinds of conduct which may have a potential negative effect on competition. Examples of certain conduct which would concern the Commission include but are not limited to:-

- <u>Predatory pricing</u>, where prices are set below production costs in the short term in order to eliminate competitors and increase long term profits.

- <u>Foreclosure</u>, where the customer is forced to enter into a long term supply arrangement with a particular supplier, limiting competition in the market through customer choice restriction. Often these agreements will include customer penalties for early termination of the agreement.

- <u>Refusal to supply</u> to actual or potential rivals goods or services which are necessary for market participation.

- <u>Bundling</u>, which involves a refusal to supply a good or service separately from another good or service forcing consumers to purchase the bundle rather than just the service they want.

- <u>Parallel pricing</u>, where there is collusion between rivals to vary prices in step.

- Other pricing and supply behaviour described under the Guideline on Dominant Position.

c. The Commission does not contend that the above examples of conduct will necessarily result in a substantial lessening of competition *per se.* The Commission will however closely monitor the market impact of such conduct.

d. It should be noted that some of the above examples are also directly addressed by specific provisions of the Act. In particular, sections 135 and 136 place prohibitions on certain practices. The Commission is

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not bound to intervene against a certain form of conduct under any particular provision of the Act, but reserves the right to take action under any relevant provision.

6.2 "Purpose" and "Effect"

a. The concepts of "Purpose" and "Effect" are relevant to sections 133 and 139 of the Act respectively. Applying these two tests imposes different requirements on the Commission.

b. The issue of the purpose of conduct is particularly relevant to the implementation of section 133. Only conduct with the *purpose* of substantially lessening of competition is prohibited under the section. Such conduct is prohibited irrespective of its effects, although the Commission expects that conduct without an effect of substantially lessening competition is unlikely to come to its attention in any case.

c. In contrast, section 139 gives the Commission the power to direct a licensee which is in a dominant position in a communications market, and engaging in conduct with the *effect* of substantially lessening competition in that market. This power is available to the Commission irrespective of the purpose of such conduct. Similarly, section 144 provides for the Minister to make rules to deal with conduct which will or is likely to lead to substantial lessening of competition in a communications market, irrespective of the purpose of that conduct.

d. Determining the purpose of conduct is often difficult. The broader principles that the Commission will apply in order to infer purpose will include:-

- the nature of the conduct, including its scope to affect rivals in the market;
- the circumstances of the conduct, including the process of decision-making which led up to the conduct; and
- the likely effect of the conduct, where likely refers to reasonable possibility rather than probability.

e. It is possible for conduct to have more than one purpose. A licensee will be deemed to have engaged in conduct with a particular "Purpose" if that purpose is or was a substantial purpose of the conduct. This means that the particular purpose should be one of the purposes of the conduct and have been material to the decision to engage in the Conduct.

f. The Commission has extensive powers of inquiry and investigation which it can employ to determine whether any or all of these conditions are met. The Commission will use such powers if it has reason to believe that a breach of the Act has occurred.

g. In contrast, determining the effect of conduct is a matter of fact which can be determined by "examination of the results". In the particular case of section 139, the issue is whether the conduct of a licensee has led to or may lead to substantial lessening of competition in a market where that licensee is in a dominant position. In this case, the issue of purpose is irrelevant, and only the assessment of whether

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substantial lessening of competition has occurred or may occur is necessary in order to activate the provisions of section 139.

7. Proposed analytical process

The Commission proposes to adopt the following three-step approach in determining matters concerning the substantial lessening of competition. This approach will provide clarity and transparency to the process of determination and will ensure consistent consideration of economic regulation issues. . It is to be noted that this process as defined is intended as a conceptual and analytical framework within which evidence can be organised. While it identifies areas of evidence which are relevant to the case in question, the Commission may be constrained by the extent of evidence available. This process is set out in Exhibit 1:-

Exhibit 1 Proposed Analytical Framework For Substantial Lessening Of Competition

	Define the Context	Define the Market	Assessment of Conduct
Objective	Ensure that the Commission has appropriate powers to act	Define the boundaries of the relevant market.	Determine whether there is (or may be) a substantial lessening of competition within the relevant market.
Process	Consider which section of the Act the assessment is being made under. Identify the circumstances which initiated the assessment. Identify the key stakeholders in the process.	Identify all demand substitutes for the service. Identify all supply substitutes for the service. Determine the relevant product market. Determine the relevant geographical market. Determine the relevant temporal market.	Assess the likely changes in the degree of competitive rivalry in the absence of Commission intervention in the light of test criteria. Assess the likely changes in the degree of competitive rivalry in the case of Commission intervention in the light of test criteria. Assess the difference in the level of rivalry between the two cases. Assess whether the difference is substantial in the light of the objects of the Act and national policy objectives.

7.1 Review the Context

a. This step requires an initial assessment of the issue, particularly whether section 133, section 139 or section 140 is relevant, prior to conducting a full assessment. The Commission will consider the purported importance of the issue or situation, including the circumstances in which it has arisen (including whether a complaint has been made, and by whom), the likelihood that Commission intervention is necessary to address it, and the likelihood that the benefits of intervention will outweigh the costs.

b. The Commission will make an initial judgement on whether the circumstances of any issue related to an actual or alleged substantial

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lessening of competition justify proceeding to a full investigation. The assessment of whether substantial lessening of competition has or may occur is relevant to the implementation of sections 133, 139 or 140. However, the procedures associated with each section are different.

c. When considering action under section 133, the Commission expects that it will have been alerted in some fashion to conduct in a market which appears to have the purpose of substantially lessening competition. Possible actions open to the Commission are to seek interim injunctions or fines against the conduct.

d. When considering action under section 139, the Commission expects that it will have been alerted to conduct in a market which appears to have the effect of substantially lessening competition. Having determined that a licensee is in fact in a dominant position in the relevant market, the Commission may then direct the licensee to cease the conduct and to implement appropriate remedies.

e. When considering action under section 140, the Commission will have received an application for authorisation of conduct. Possible actions open to the Commission are to issue an authorisation of the conduct, or to refuse the application on the grounds that the authorisation would not be in the national interest. The Commission will have regard to any benefits claimed in the application for authorisation in making its assessment.

f. In all cases, the Commission will make an initial assessment of the impact of the conduct or proposed conduct on the level of competition. In judging whether a conduct requires the Commission to proceed to a full investigation of that conduct, the Commission will have regard to the following criteria which it will apply as appropriate on a case-by-case basis:-

- the likelihood that continuation of the conduct will encourage other licensees to engage in the same or similar conduct;
- whether any person has informed the Commission of any loss or damage as a result of the conduct;
- whether the conduct has already ceased or not;
- whether Commission action would clarify the nature of the conduct;
- whether the conduct is likely to have adverse impact on end-users;
- whether Commission action would serve to alert end-users to the adverse impacts of the conduct;
- whether the costs of Commission action would outweigh the benefits of the action; and
- the likelihood that another licensee might take its own action over the conduct.

7.2 Define the Communications Market

<u>The Malaysian context</u>

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a. The Malaysian regulatory regime is not confined to the telecommunications sector alone. It must have regard to all sources of actual or potential competition in a communications market. This includes the use of mobile and other wireless access technologies (including, for example digital broadcasting and datacasting). It is for this reason that the Act specifically defines a "Communications Market" as an economic market for:-

- a network service;
- an applications service;
- goods or services used in conjunction with a network service or an applications service (eg., television and telephone equipment, or billing services); or
- access to facilities used in conjunction with a network service or an applications service.

b. It is important to recognise that these market definitions do not correspond to traditional telecommunications markets. These definitions are underpinned by a "convergence" model of communications industry activity which recognises the trend for traditionally separate service markets to merge as technological change generates new opportunities for competitive rivalry. A communications market is generally larger and more competitive than a telecommunications or broadcasting market.

Exhibit 2 Market And Services Structures In The Convergence Sector

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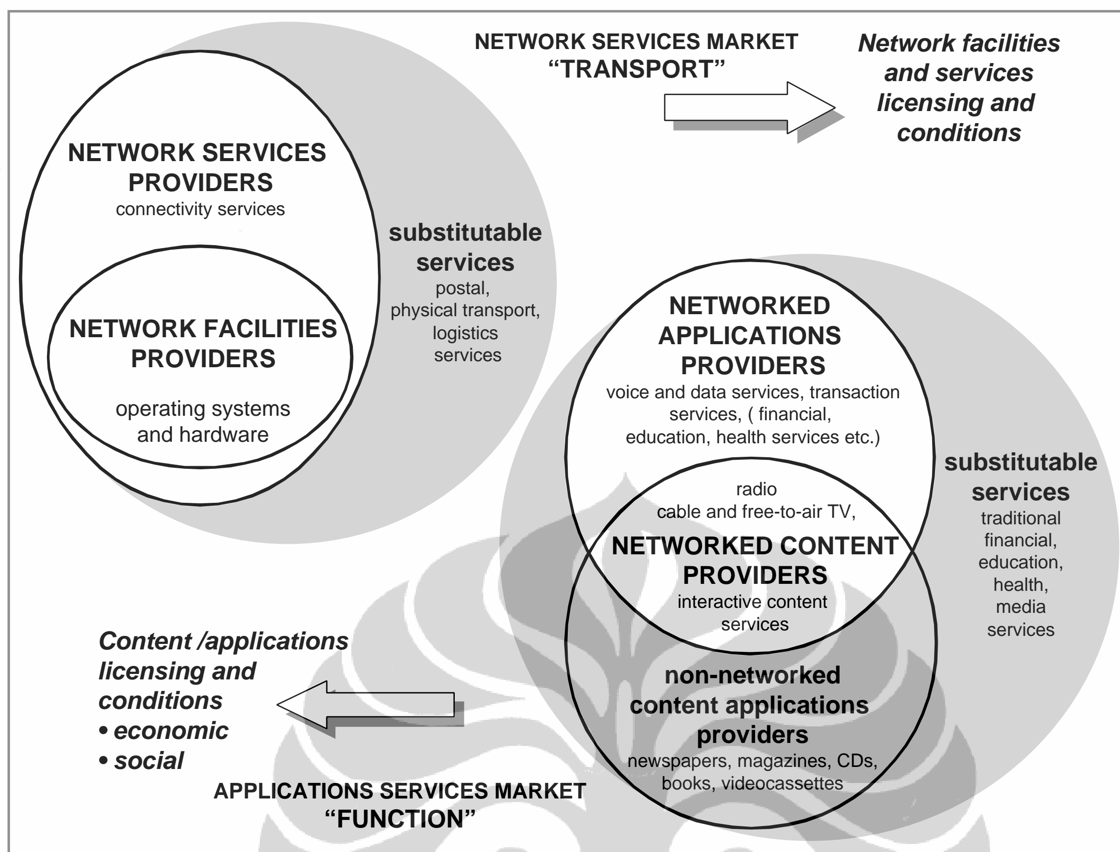

"Economic Market"

c. Reference to a "market" should be taken as reference to a communications market for the purposes of reading this guideline. In the exercise of its powers in the Act, the Commission has decided to adopt a definition of "market" based on the economic concept of "substitutability". Two goods or services will be treated as being in the same market if, and only if, they are substitutable for a purpose. Within the bounds of a market, substitution between goods and services occur in response to changing prices. It is these possibilities of substitution which prevent a firm from changing its prices without provoking a response from other suppliers in the market.

d. This approach is consistent with the approach adopted in a wide range of jurisdictions. In OFTEL's Guidelines on the Operation of the Fair Trading Condition, the UK telecommunications regulator stated that:-

"The approach to market definition ... focuses on the existence of constraints on the price-setting behaviour of firms ... A main consideration is the ease with which it is possible to substitute relevant services is response to movements in prices. There are two main aspects to consider: how far it is possible for customers to substitute other services or products for those in question, and how far suppliers not presently providing the products and services in question can readily do so ..."

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e. In Hong Kong, in the Office of the Telecommunications Authority (OFTA)'s Guidelines to Assist the Interpretation and Application of the Competition Provisions of the FTNS Licence, the following approach has been adopted:-

"... the TA will adopt the economic concept of a 'market' as it has been applied in antitrust law. That is, the TA will use the generally accepted test of 'substitutability' or 'cross-elasticity' in both demand and supply. Essentially, a market is an area of close competition or potential competition, and defining a market involves assessing which products are close enough substitutes to be said to be competing in the same market".

f. The Australian courts have developed a similar interpretation of Australian trade practices legislation. In a decision by the Australian Trade Practices Tribunal, it was stated that:-

"A market is the area of close competition between firms, or putting it a little differently, the field of rivalry between them ... Within the bounds of a market there is substitution: substitution between one product and another, and between one source of supply and another, in response to changing prices. So a market is the field of actual and potential transactions between buyers and sellers amongst whom there can be strong substitution, at least in the long run, given a sufficient price incentive ... Whether such substitution is feasible or likely depends ultimately on customer attitudes, technology, distance and cost of price incentives. ... in determining the outer boundaries of the market we ask a simple but quite fundamental question: if the firm were to 'give less and charge more', would there be, to put the matter colloquially, much of a reaction?" (Queensland Co-op Milling Association Ltd v Defiance Holdings Ltd)

g. Substitutability, therefore, has both a demand-side and a supply-side dimension. The main considerations are the ease with which purchasers are able to replace particular goods or services used for a purpose with substitutes, and the ease with which suppliers currently producing substitutes for a purpose can produce the particular goods or services in question. Purchasers and suppliers who are able to make these substitutions are operating in the same market.

h. The demand side form of substitution is dependant on how easily customers can substitute the products in question for those of a similar nature, which can be referred to as the cross-elasticity of substitution between products. It is essential that the transfer between the products can be undertaken by the consumer with relative ease, the costs and effort must be minimal. Note that it is not required that the products be perfect substitutes, but must fulfil the purpose of the original product. The existence of such products may restrict the price setting behaviour of the firms in the market to a certain extent, but again, this is dependent on the factors mentioned in the above discussion.

i. On the supply side, substitutability is dependent on the ability of other firms not already providing the goods and services in question to do

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so. This is known as the cross-elasticity of supply. In order for there to be a high degree of substitution in this case, other firms must be able to begin supply with relative ease. Hence, the market boundaries on both supply and demand sides are defined by the other products available that can act as substitutes for the product. Such products provide direct competition.

j. The identification of the relevant purpose is fundamental to the definition of the market. Goods or services which are substitutable for one purpose may not be substitutable for another purpose. The identification of the relevant purpose must be performed in the light of the conduct being examined, the scope of the impacts which the conduct may have, and the importance of the purpose in question in the light of the policy goals set out in this guideline.

k. An example is whether conduct by a supplier of apples should be regarded as conduct within the market for apples, or the market for fruit, or the market for food. Any or all of these market definitions may be relevant, depending on the impacts the conduct has in each market and the significance of those impacts.

Factors affecting substitutability and market definition

l. Substitutability may be limited by a large number of factors. Amongst the most important are:-

- that two goods or services may not be substitutable for a particular purpose (although this does not rule out the possibility that they may be substitutable for some other purpose). In this case the two goods or services are in different product markets;
- that two goods or services may be geographically separated, and hence unavailable for substitution. In this case the two goods or services are in different geographical markets; and
- that two goods or services may not be available at the same time, and hence unavailable for substitution.

m. These three factors of substitutability correspond to the three most important aspects of market definition:-

- the *product* dimension, which requires the identification of the bundle of goods or services supplied by the firm and by actual or potential sources of alternative supply.
- the *geographic* dimension, which involves the identification of the area or areas over which a firm and its rivals are able to compete, and to which customers can practically turn given a sufficient price incentive. This price incentive may result in a customer switch to an actual rival, or may encourage entry by a potential rival.
- the *time* dimension, which involves the identification of the period over which substitution possibilities should be considered. Generally the Commission will consider

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substitution possibilities over the long term, but foreseeable, future.

n. When determining markets for the purpose of examining the level of competition, it is necessary to identify the conduct supposed to affect the level of competition, and determine markets in a way which provides insight into the impact of that conduct. A too-narrow determination can suggest substantial lessening of competition where there is none, and a too-wide definition can suggest that there is no substantial lessening of competition when there actually is.

o. In many cases, the Commission expects that the best evidence for determination of markets will come from suppliers and purchasers themselves, who are best placed to be aware of their rivals and their supply choices respectively. From time to time the Commission may use its powers of inquiry and investigation to gather such evidence for the purposes of determining a communications market.

7.3 Assessment of Conduct

a. Once the market has been defined, the Commission will determine whether the situation justifies action under the Act. In the case of conduct purported to have the purpose of substantially lessening competition, the Commission will be required to apply "test" criteria developed in paragraphs (c) to (r) below.

b. In the case of an application for authorisation under section 140, this will require the Commission to make a forward-looking assessment both of whether the proposed conduct will or may substantially lessen competition, applying the criteria of section 6, and of the benefits of the conduct in the light of the national policy objectives. An assessment of the net benefits of the conduct will then be made.

The Meaning of "Competition"

c. OFTA has defined competition in its Guidelines to Assist the Interpretation and Application of the Competition Provisions of the FTNS Licence as follows:-

"The TA ... takes as its starting point that competition is a process whereby there is rivalry in a market between suppliers in relation to certain types of goods or services provided to consumers, the prices at which they are supplied and the additional services which are offered or supplied".

d. The close relation between "competition" and "market" definitions is apparent from this definition. In particular, the concept of rivalry between firms underpins both concepts.

e. The definitions of market quoted earlier all included potential rivalry, in addition to actual rivalry, as a source of substitutes. In these jurisdictions, the availability of potential substitutes is regarded as an important source of rivalry and hence competition. The Commission adopts a similar view. Both actual and potential rivalry are important

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constraints on firm behaviour in a competitive market, although one or other factor may be more important, depending on the circumstances.

f. Competition is the process of actual or potential rivalry between firms in a market. The level of competition in a market is simply the level of this rivalry. "Lessening competition" therefore means a reduction in the level of actual or potential rivalry between firms in a market.

g. The Commission's view is that its role is to protect competition, namely the process of rivalry between firms. It is not the role of the Commission to protect any particular participant in that rivalry.

Actual rivalry

h. Factors which the Commission will normally regard as indicators of the actual level of competitive rivalry in a market include:

- The number of independent suppliers

  The greater the number and independence of suppliers in a market, the more likely suppliers are to be direct rivals and the higher the level of competition is likely to be.

- The degree of market concentration

  The lower the degree of market concentration, the less the relative market share of competitive rivals. In these circumstances it is more likely that rivals will be forced to respond independently to price signals and that levels of actual competition will be higher.

- The level of product or service differentiation

  The less the level of product or service differentiation, the greater the ease of substitutability and the greater the number of rival sources of supply. This generally results in a higher level of competition.

- The extent of vertical integration with firms in upstream and downstream markets

  Vertical integration can provide opportunities for an integrated firm to extend market power in one market into the market in question. This might include conduct which impacts on the independence its rivals, for example by manipulating prices in intermediate markets or by imposing conditions in intermediate markets. This could lead to lower levels of rivalry and competition.

- The nature and enforceability of any arrangements between firms in the market which restrict their independence of action

  Agreements between rivals to cooperate on certain matters can reduce the level of rivalry and hence of competition in the market. Such agreements can only have these impacts when participants cannot readily defect from them.

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Potential rivalry

i. Actual factors are not the only ones which must be considered. Potential sources of rivalry can also play an important role in influencing the behaviour of market participants. The knowledge that raising prices might attract new firms to a market can constrain pricing, even in the absence of actual competitors.

j. This point is particularly important in a developing market such as Malaysia, where a significant proportion of the addressable market does not yet have access to communications services. All things being equal, the barriers to entry in such markets are lower than they would be if Malaysia enjoyed ubiquitous infrastructure.

k. Factors which are indicators of the potential level of competitive rivalry in a market include:-

- The height of barriers to market entry and exit

  Lower barriers to entry and exit will generally mean a higher propensity for potential rivals to enter the market in response to the commercial opportunities created by the actual rivals' conduct in the market. Both barriers to entry and exit are relevant. An inability to exit a market can discourage potential investors just as effectively as a barrier to entry if it exposes the investor to the risk of financial loss.

- The presence or absence of technology and market developments which are leading or are likely to lead to substitutes.

  The circumstance of rapid technological change in a market suggests that substitutes for a particular purpose may be more readily available in either the short or the long run. This factor will be particularly persuasive where such substitutes are actually available.

"Substantially"

l. The term "substantially" has antecedents in Australian trades practices law. In *Cool & Sons Pty Ltd v O'Brien Glass Industries Ltd,* the Australian Federal Court described "substantially" in "substantially lessening competition" in the following terms:-

  "It must be capable of being fairly described as a lessening of competition that is real, or of substance as distinct from a lessening that is insubstantial, insignificant or minimal."

m. In the Explanatory Memorandum to the *Trade Practices Revision Bill 1986*, it was stated that:-

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> *"... in the context of section 46* [which refers to 'substantial lessening of competition'], '*substantial is intended to signify 'large or weighty', or 'considerable, solid or big' ".*

n. In one of the most considered comments on this issue, Smithers J outlined the following approach to the degree of lessening of competition required to constitute a substantial lessening:-

> *"To my mind, one must look at the relevant significant portion of the market, ask oneself how and to what extent there would have been competition therein but for the conduct, assess what is left, and determine whether what has been lost in relation to what would have been is seen as a substantial lessening of competition. ... it is the degree to which competition has been lessened which is critical, not the proportion of that lessening to the whole of the competition which exists in the total market. Thus a lessening in a significant section of the market, if a substantial lessening of otherwise active competition may, according to circumstances, be a substantial lessening of competition in a market". (Dandy Power Equipment Pty ltd & Anor v Mercury Marine Pty Ltd, 1982 ATPR sec 40-315)*

o. In the Malaysian context, the significance of any reduction in the level of competition will be determined in the context of the objects of the Act and the national policy objectives set out in the Act. Where the conduct has a significant negative impact on those policy objectives and goals, it will be judged a significant lessening of competition for the purposes of section 133.

p. A reduction of the number of suppliers in a market does not, of itself, constitute a substantial lessening of competition, or even necessarily a lessening of competition. A judgement about the impact of a reduction in the number of suppliers can only be made in the light of its impact on the level of rivalry in the relevant market or markets.

q. Further, the reference to "consumer choice" in the Explanatory Statement necessarily cannot mean that a certain number of suppliers must be maintained, since that is impossible to guarantee in the normal course of events in any case. The Commission's view is that "choice" in this context refers to the potential to choose between suppliers, rather than having access to a certain fixed number of suppliers.

r. Conduct which appears to have little short run impact can have significant long run impact and the Commission will usually only have regard to purposeful conduct with long run impact. However, short run impact will be considered where they are likely to have long run consequences for the level of competition in a communications market.

7.4 This Guideline comes into effect on February 1st 2000 and TRD 008/98 (ANTI-COMPETITIVE BEHAVIOUR IN THE TELECOMMUNICATION INDUSTRY) will cease to have effect from the same date.

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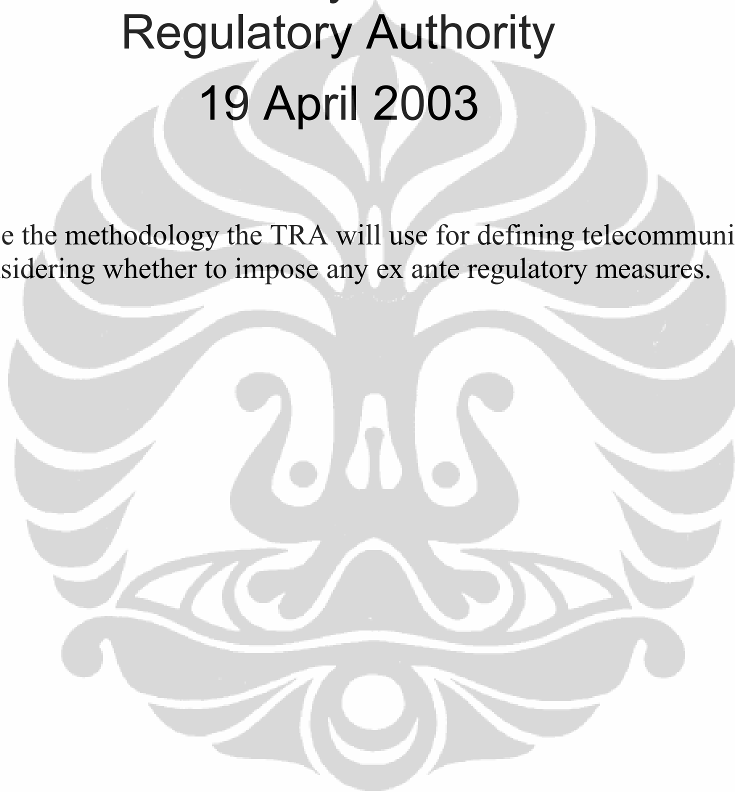
DETERMINATION

Methodology for the Definition of Telecommunications Markets

Methodology for the Definition of Telecommunications Markets

A Determination issued by the Telecommunications Regulatory Authority

19 April 2003



Purpose: To describe the methodology the TRA will use for defining telecommunication markets in Bahrain when considering whether to impose any ex ante regulatory measures.

هيئة تنظيم الاتصالات
Telecommunications Regulatory Authority

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DETERMINATION

Methodology for the Definition of Telecommunications Markets

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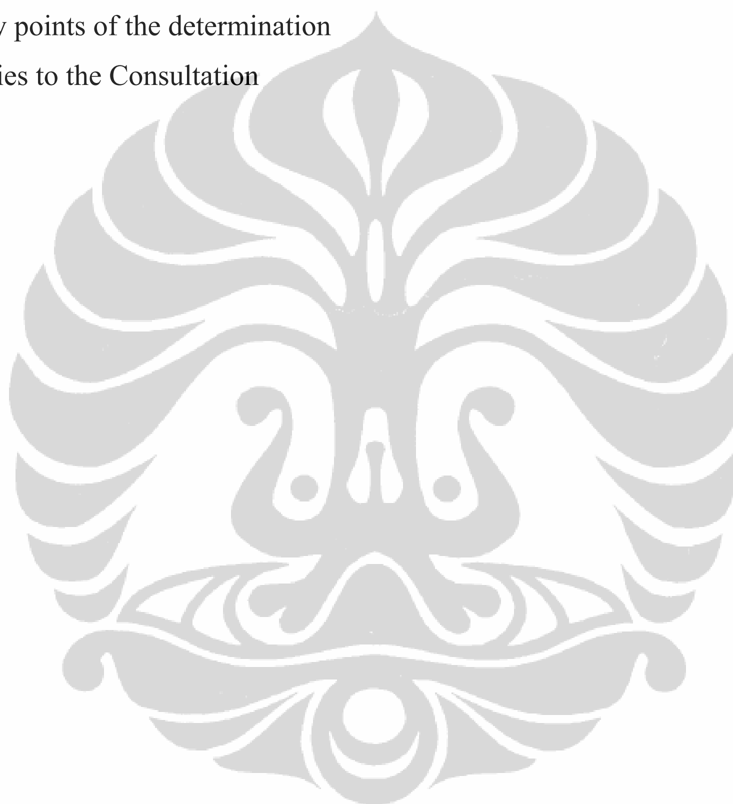

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DETERMINATION

Methodology for the Definition of Telecommunications Markets

1 Introduction

The Bahraini primary legislation (Legislative Decree No. 48 of 2002 promulgating the Telecommunications Law) provides a definition of dominance and SMP, but leaves it to the TRA to determine the methodology it will follow in defining relevant markets, and specifying the markets in which an organisation has dominance or SMP. This determination describes the methodology the TRA will use for defining telecommunication markets in Bahrain, when considering whether to impose any regulatory measures. It has been prepared following the publication of a consultation paper[1], the receipt of replies to that paper, and the TRA's consideration of those replies.

1.1 Process

In general, the regulatory process will follow the steps outlined below:

1) The TRA will define relevant telecommunications markets that may be considered for the application of some form of regulation;

2) The TRA will investigate whether the market is sufficiently competitive or expected to become so in the near to medium term such that any regulatory intervention would be unwarranted, by undertaking a market dominance/significant market power analysis.

3) If the market is not likely to become effectively competitive then the TRA will identify which operator or operators are dominant or have significant market power in a relevant market or markets.

4) The TRA will then identify the most appropriate regulatory measures to apply. It is possible that regulatory measure would be targeted at another market than that where the results of the market failure are most apparent, especially upstream bottleneck markets.

5) The TRA will define appropriate regulatory instruments and quantify any direct measures that that will be employed.

The overall objective of the TRA in undertaking this process will be to enhance user and consumer benefits in terms of choice, price and quality by encouraging competition in the supply of services.

[1] This document is available on the TRA's website.

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2 Definition of 'relevant markets'

Under Bahraini law the imposition of *ex ante* regulation on any licensee must be based on a finding of either market dominance (section 57), or in the case of sections 58 and 64, on significant market power (SMP). These concepts are defined in the law. They are concerned with market power. *Ex ante* regulation is primarily intended to address the problems associated with market power.[2]

Market power implies a lack of effective competition. The problems associated with a lack of effective competition are well documented and include excessive prices, a lack of responsiveness to customer needs, high levels of operational inefficiency, and a range of other problems that detract from the economic wellbeing of citizens compared to a situation where the provision of services occurred in markets that were effectively competitive.

In order to identify a **relevant market**, requires the identification of the **goods or services** traded in that market, and an **area** in which a hypothetical monopolist could profitably sustain a rise in the price(s) of those goods or services. Further clarification may be provided by also describing the functional level of the market. The definition of the market is crucial in order to determine whether any firm has dominance or SMP in that market.

2.1 Definition

The concept of market definition has been developed over the last 20 years or so, mainly by economists working with various competition law authorities. The concept of market definition as used by competition authorities is now highly developed, although nevertheless a complicated exercise.

The leading contributor to this development has been the US antitrust authorities, especially the Department of Justice (DOJ). In 1982 the DOJ developed the hypothetical monopolist test for the purpose of providing an analytical framework for market delineation. The wording of this test has been slightly modified since this time.[3] It requires that the practice of defining markets should start from a competitive price, and enquire whether it be profitable, over a period of about one year, to implement a hypothetical small (in the range of 5 to 10 %) increase in price? In any particular case the answer to this question will depend on the degree to which consumers would switch to other products (demand substitution) and the degree to which additional supply would materialise (supply substitution).

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[2] Another form of market failure that regulation may address are know as 'externalities'. When regulating the telecommunications sector, the existence of externalities may result in the TRA designing regulatory mechanisms so as to take account of some form of externality.

[3] "*A market is defined as a product or group of products and a geographic area in which it is produced or sold such that a hypothetical profit-maximizing firm, not subject to price regulation, that was the only present and future producer or seller of those products in that area likely would impose at least a "small but significant and nontransitory" increase in price, assuming the terms of sale of all other products are held constant.*" Section 1.0 Horizontal Merger Guidelines, DOJ, issued 1992, revised 1997.

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The application of the market definition process to the ex ante regulation of telecommunications is relatively recent, and is not problem free. As respondents to the consultation pointed out, due to peculiarities in telecommunications industry that are not shared by many other industries, the test must be applied with skill in order to prevent a bias toward markets being too narrow defined.[4] The TRA will take the appropriate care in this regard.

The hypothetical exercise is relevant only in the context of the economic assessment of where the boundaries lie regarding relevant markets. It is not directly relevant for analysing whether an entity has dominance or SMP in a relevant market. (This part of the analysis will occur after the relevant market has been identified). In applying the test, the TRA will take care not to begin with a geographic scope that is too broad, nor with a group of products or services that is too broad.

In general, the TRA will begin with the end-user product or service that appears to be at the core of the market power problem. This will require the TRA to identify the functional level on which the market power problem is centred. The hypothetical monopolist test will then be applied.

In its design the hypothetical monopolist test is concerned with the response of consumers at the margin (i.e. those most likely to switch) and *not* the average or typical user. It is whether these marginal customers are sufficient in number to make any attempt by a firm to increase prices for a product unprofitable, that is important for market definition purposes. While there may be many customers who would not switch under any realistic circumstances, this has no relevance to the outcome of the SSNIP test[5]. Ultimately, it is an empirical matter, and one that cannot be addressed by simple factual analysis and assertions (which risk being arbitrary and capable of mistakenly identifying very narrow markets).

In practice, the TRA may not start the process with individual products or services, as there may be several unmistakably strong and effective substitutes for the product or service in question. Consequently, the TRA may begin by applying the test to a range of obviously substitutable products or services.

The TRA agrees with respondents, that the test can not be applied in a mechanistic way. Peculiarities with the telecommunications industry require the test to be applied intelligently, and even here, where so many costs are common between 2 or more services, the application of the test must not overlook groupings of goods or services, where the demand or supply complementarities are such as to make stand-alone provision non-viable (see the Annex for a more detailed explanation).

The TRA will follow this methodology for defining relevant markets.

2.2 Timeframe for analysis

Under competition law the process of market definition requires subtle differences depending on whether the process is motivated by the investigation of an alleged restrictive trade practice (RTP) or abuse of dominance, or whether it is in regard to a merger or acquisition. RTPs or abuses of dominance involve the investigation of events

[4] The issues are discussed in a little more detail in the annex to this determination.

[5] SSNIP stands for "Small but significant and nontransitory increase in price".

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that have already taken place. Consequently, the enquiry is one which assists them in defining the market that existed or exists at the time of the impugned event, i.e., in the past or present. As for merger analysis, however, it is the "predictable" future that is most important for market definition for the purposes of *ex ante* regulation. There is no information available from a future period.[6]

As for merger analysis, market definition for the purposes of applying *ex ante* regulation requires that TRA to define markets taking account of the predictable future. The standard timeframe within which markets are usually delineated using the hypothetical monopolist test applied to merger regulation is 1 year. Concern has been voiced that this timeframe may be too short and result in relevant markets being too narrowly defined for the purpose of telecommunications regulation. It has been suggested that in dynamic markets characterised by factors such as evolving technology and technological applications, new innovative business models, and an evolving regulatory structure, markets will tend to be too narrowly defined, with the result being that dominance or SMP may be too readily found, and regulation imposed that undermines more cost-effective market-based solutions.

In order to delineate a market the TRA will look to the coming 1 to 2 years in order to make an assessment of whether market power (be it dominance or SMP) is likely to be enduring. If commercial events are thought likely to occur outside of a 1 to 2 years period (as discussed above), the TRA will consider these possible events when deciding whether the impose any regulation, and in the design of any such regulation.

2.3 Treatment of supply substitution

In the consultation paper the TRA asked respondents for their views on the differences between US and EU jurisdictions in the way they treat supply substitution. In the European Union supply substitution is included in the process of market definition. In the US supply substitution is considered in the identification of firms that provide sufficiently similar services to constrain the behaviour of those firms that are currently offering the service in question. In effect, the respondents seem to have agreed that the difference is found in the application of the two approaches, rather than in principle.

The TRA has decided to adopt the EU approach to addressing supply substitution. The TRA's reasons for this choice are partly based on the fact that Bahrain retains an integrated incumbent operator as has occurred in the EU as well as Australia and New Zealand, and markets definition and precedent from those jurisdictions are thus likely to be of more relevance to Bahrain than are the market definition and precedent taken for the US.

[6] In regard to restrictive trade practices (RTP) or abuse of dominance, the investigation involves events that have already taken place. Consequently, the relevant market the authorities are in need of defining, will actual have existed at the time of an alleged illegal event.

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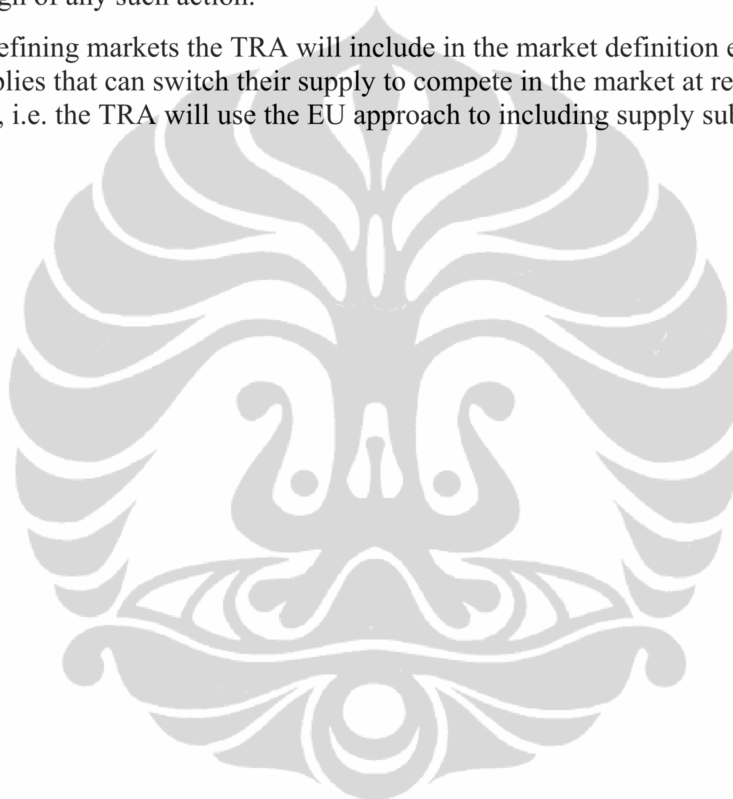
3 Summary of key points of the determination

- The TRA is required by law to identify dominance or SMP in *markets* prior to implementing regulations;
- The TRA will employ the hypothetical monopolist test to identify *relevant markets*;
- The TRA will employ a forward-looking approach to defining markets, and this will be limited to 1 to 2 years.
- Commercial developments that are thought likely to occur after this period will be considered by the TRA when it decides whether to take regulatory action and in the design of any such action.
- In defining markets the TRA will include in the market definition exercise, other supplies that can switch their supply to compete in the market at relatively little cost, i.e. the TRA will use the EU approach to including supply substitution.



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A1 Annex - Replies to the Consultation

The TRA received two replies to the Consultation paper on market definition: one from Batelco and one from Kalaam Ltd.

One respondent recommended that the TRA make explicit its intention to also look at the *function level* of the market as well as defining markets in terms of the Product and Geographic Area of the market. The respondent was keen that the TRA guard against market definitions that were not adequately focussed on the vertical level of the value chain, and which may therefore result in *ex ante* regulation being applied in areas where competition should instead be relied upon.

Both respondents pointed out the difficulties posed by 'clusters' of goods or services, with one warning that for the purposes of market definition, cluster markets should only be defined where certain conditions exist. These conditions have been outlined by economists and include the requirement that:

- unbundling of consumption imposes identifiable costs on consumers;
- these costs are substantial relative to the level of outlays on the cluster of the consumers accounting for a large share of consumption;
- demand for the items comprised in the bundle is correlated among consumers;
- the items are broadly similar in terms of the factors which generally shape firms' marketing strategies; and
- suppliers' market shares for each item in the cluster respond to the prices they charge for the other items.

This is in addition to the more general supply-side issue noted in the consultation document in regard to the various services provided with 2G and 2.5G mobile technologies, i.e. that of economies of scope such as to make stand-alone provision of certain individual services uneconomic. One respondent urged the TRA to consider the potential for services to be rightly included in markets at the outset, following an analysis of the demand and supply characteristics.

Also raised by this respondent were the difficulties of applying the SSNIP test in industries with large sunk costs. The implication is that prices in such industries will already be in excess of marginal cost, meaning that if prices are marked up above marginal cost by 5%-10%, as is recommended by the SSNIP test, the result may indicate a lack of substitutability into other services / products erroneously suggesting an anti-trust market where such mark-ups can be too little to allow a hypothetical monopolist to earn a sufficient return on its capital - including its fixed costs.

The TRA acknowledges that the SSNIP test for market definition requires that the SSNIP test must be applied carefully, and not as it would be for industries where fixed costs were less important.

Both respondents note that in industries characterised by rapidly developing technology, the traditional SSNIP will result in markets that are too narrowly defined. Indeed, a few academic commentators have suggested that the test should be fundamentally modified so as to include other performance variables such as innovation, and the effect of product innovation on customer response.

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The TRA is not confident, that in practice these other factors could be well enough assessed to make for a sufficiently robust methodology, enabling the adaptation of the present approach to market definition, to make it suitable for industries characterised by rapid technological innovation.

At present these factors are assessed during dominance / SMP tests, when the authorities would make an assessment of whether market power exists, the causes of that market power, and thus decide on a suitable regulatory response if regulation was considered necessary. While these aspects are currently being investigated in preparation for further developments to the new telecommunications regulatory framework in the EU, the TRA takes the position that in difficult cases, such as where there are important non-price factors e.g. large sunk investments in R&D that suggest that competition may [also] be *for the market* rather than simply *in the market*, these factors will be considered when reviewing the causes of market power.

The TRA also notes that while technological development has been very important to the telecommunications industry, much of the development has occurred outside of telecommunications networks or service providers, through firms that design, make and sell equipment to telecommunications networks or service providers. Network operators have tended to be buyers of this technologically rich equipment on an international market, rather than being the inventors of it. Because of this, the particular problems of applying the SSNIP test to highly innovative industries, would appear to be of rather less important for national telecommunications regulatory authorities than some commentators have claimed.

On the question of supply substitution, specifically whether the EU or US approach to including supply effects in the market analysis exercise, the respondents were of contrasting views. While one acknowledged the results provided in both cases should be similar, its preference for the US approach was based on a wish to avoid the authorities guessing at the predicted supply response following a hypothetical SSNIP price rise. The other's preference for the EU approach (also shared by Australia ad New Zealand), was that the US approach would result in confusion and duplication of analysis.

In regard to the TRA's request for comments on the timeframe over which the market analysis should take place, both respondents have urged that a flexible approach be used, although with one urging a longer period compared to the other's suggestion that in most cases a 1 year timeframe would be appropriate.

Finally, one respondent urged the TRA to commit to reviewing its market definitions in 12 months, rather than for the TRA to retain its discretion to choose to review these definitions within 2 years unless the conditions warranted an earlier review.

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