GLOBAL COMPETITION REVIEW

The international journal of competition policy and regulation

An extract from

The 2005 Handbook of Competition Economists

June 2005

In association with CapAnalysis

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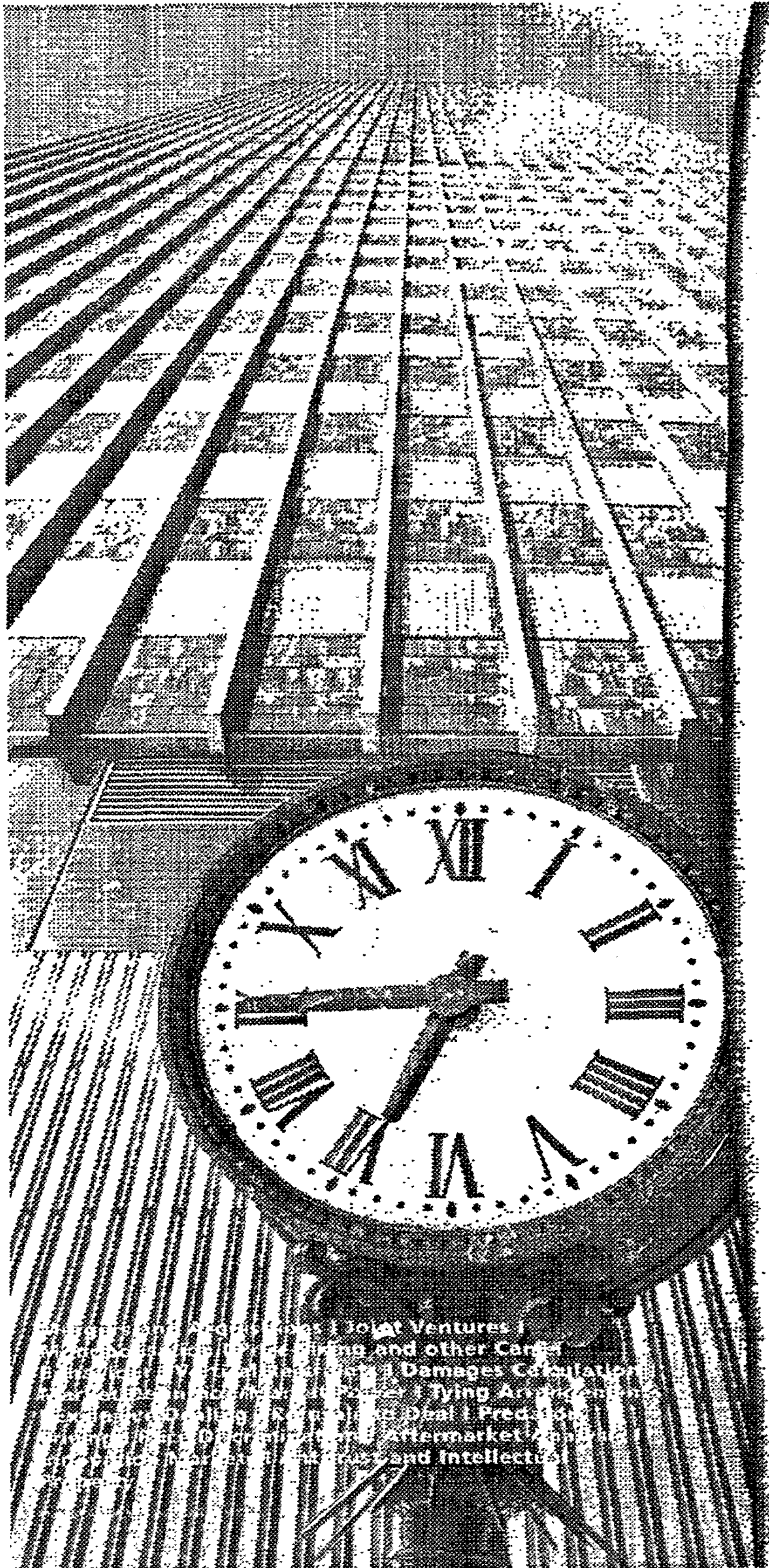

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Multijurisdictional merger control: relevant economic evidence

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The year 2004 was a landmark year for merger control in both the United States and the European Union. Both US agencies, the Department of Justice (DoJ) and the Federal Trade Commission (FTC), lost high-profile attempts in court to block two mergers, *US DoJ v Oracle Corp* and *FTC v Arch Coal*, whose reviews started in 2003. On 1 May 2004, the European Commission (the Commission) ushered in a revised merger reform framework (and general modernisation of its competition policy) and in December 2004 blocked one merger, EDP/GDP, an electric and gas utility combination in Portugal, but cleared two high-profile mergers that had already undergone full US scrutiny (Sony/BMG and Oracle/PeopleSoft). The prohibition of the EDP/GDP merger marked the first prohibition since 2001 when Mario Monti, the then EU competition commissioner, blocked two acquisitions, Schneider/Legrand and TetraLaval/Sidel, followed by both decisions being famously overturned by the Court of First Instance.

Economics played significant roles in all of these matters on both sides of the Atlantic. Judge Walker's opinion in the Oracle matter illustrates the importance of economic evidence in merger control.

"Despite the problems with qualitative analyses, modern econometric methods hold promise in analysing differentiated products unilateral effects cases. Merger simulation models may allow more precise estimations of likely competitive effects and eliminate the need to, or lessen the impact of, the arbitrariness inherent in defining the relevant market. For example, some merger simulation methods compensate for potential errors in market definition. A model advanced by Werden and Froeb uses a set of 'inside goods' and a set of 'outside goods'." (Id at 410, *United States of America, et al v Oracle Corporation*, N.Dist. Cal, No. C 04-0807 VRW at 45.)

As the Commission has adopted a more economics-based competition-merger policy with a refreshed look at its substantive tests, observers have speculated that this effects-based approach will contribute to more international enforcement convergence. Guidance from the Court of First Instance warns the Commission that sufficient economic evidence must support its decisions.

"Whilst the Court recognises that the Commission has a margin of discretion with regard to economic matters, that does not mean that the Community Courts must refrain from reviewing the Commission's interpretation of information of an economic nature. Not only must the Community Courts, inter alia, establish whether the evidence relied on is factually accurate, reliable and consistent but also whether that evidence contains all the information which must be taken into account in order to assess a complex situation and whether it is capable of substantiating the conclusions drawn from it. Such a review is all the more necessary in the case of a prospective analysis required when examining a planned merger with conglomerate effect." (*Commission of the European Communities v Tetra Laval BV*, Case C-12/03 P, Judgment of the Court (Grand Chamber), 15 February 2005, at ¶ 39.)

An examination of the most recent parallel merger reviews by the US and the EU authorities provides a unique insight into the nature and extent of convergence between the interpretation of economic evidence and its effect on the enforcement outcomes in these two key jurisdictions. (See Best Practices on Cooperation in Merger Investigations, October 2002. Where the US and EU are reviewing the same transaction, "both jurisdictions have an interest in reaching, insofar as possible, consistent, or at least non-conflicting, outcomes." This joint statement is designed to promote "fully-informed decision-making on the part of both sides' authorities, to minimize the risk of divergent outcomes on both sides of the Atlantic, to facilitate coherence and compatibility in remedies, to enhance the efficiency of their respective investigations, to reduce burdens on merging parties and third parties, and to increase the overall transparency of the merger review processes.") This chapter focuses on two recent global mergers—Oracle/PeopleSoft and Sony/BMG—concluded in the past year that offer an opportunity to view the similarities and differences in the role played by, and the interpretation of, the economic evidence in the merger review process. It is noteworthy that both Sony/BMG and Oracle/PeopleSoft were technically reviewed under the EU's former merger control regulation, but a review of these matters indicates that great deference was given by the EU to the new Guidelines in evaluating the competitive effects of these transactions.

Oracle/PeopleSoft

Although the timing and procedural process of the parallel jurisdictional reviews were quite different, the Oracle/PeopleSoft merger review presents a good example of both the complexities and the investigational efficiencies that can result from such a joint review. An additional feature is that the US review process was ultimately concluded by an injunction trial whereas the EU process was concluded with an administrative decision. (Throughout the history of the ECMR, 19 out of more than 2,000 mergers have been blocked. Seven of these have been appealed— famously, three have been overturned by the CFI— four clearance decisions under the ECMR have been appealed by competitors.) Uniquely, the Commission decision incorporated many of the findings of the US trial court in its review, and endeavoured to maintain consistency between the two review processes.

Product market definition

In both jurisdictions, the definition of relevant markets continues to be a necessary starting point for the competitive assessment of mergers. It should be noted that the importance of market definition in unilateral effects differentiated products cases continues to be debated. The DoJ proposed that the rele-

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vant market consisted solely of high-function financial (FMS) and human resource management (HRM) enterprise resource planning software (ERP), sold by Oracle, PeopleSoft and SAP, (see Glueck and Manning. Economic Issues in Antitrust: 2003-2004, *The Antitrust Review of the Americas*, 2005 at 18-21) but presented no empirical economic evidence at trial to support this definition, relying instead on the testimony of customers and industry experts and the testimony of economic expert Kenneth Elzinga. With the burden of market definition squarely on the plaintiff DoJ, Judge Walker was unconvinced on the merits. In his opinion, customer testimony failed to address the key issue, "[b]ut the issue is not what solutions the customers would like or prefer for their data processing needs, the issue is what they could do in the event of an anti-competitive price increase by a post-merger Oracle." Walker found the testimony to be "speculative" on this issue and not supported by "serious analysis". Industry witnesses and system integrators were not found to be reliable or articulate on the market definition issue.

Judge Walker was even more direct on the need for economic analysis in his assessment of the testimony of Professor Iansiti, a professor of Business Administration at the Harvard Business School:

"Because of his [Iansiti's] lack of economic analysis and his inability to identify articulable product market boundaries (a key issue in a horizontal merger case), the court finds that Iansiti failed to establish a clearly defined product market along the lines alleged by plaintiffs." (*USA v Oracle* at 72.)

The DoJ's other expert, economist Kenneth Elzinga's evidence, was judged by Walker to be "circumstantial and highly qualitative" while relying on unreliable data (*USA v Oracle* at 125). Without any reliable supporting empirical economic evidence to the contrary, Judge Walker could not exclude other competing products and adopted Oracle's much broader market definition.

The EU's initial market investigation based on qualitative information led to the preliminary conclusion of separate markets for HRM and FMS high-function software for large corporations that could only be served by Oracle, PeopleSoft and SAP. After examining new bid data provided by Oracle and evidence presented at the US trial, the Commission concluded that other vendors had successfully won bids or had come in as the second choice or participated in the final bid rounds in other competitions. On the basis of these data, the EU concluded that at least four other vendors in addition to the 'Big 3' were market participants.

Geographic market definition

The geographic dimensions of the market differed—with the DoJ proposing a US market based on its expert's opinion, without economic empirical support, that marketing, installation, maintenance and provision of upgrades have inherently local aspects and that arbitrage between regions would be difficult. Oracle countered by producing empirical evidence showing that average discounts between Europe and the US were virtually identical (approximately 45 per cent) suggesting that European and US prices probably are constraints on each other.

Relying on the same average regional discount data presented by Oracle, the Commission concluded that the relevant geographic market was worldwide, as no specific barriers or other technical hurdles exist to limit suppliers from responding to large corporate bids worldwide, although it did allow that the relative strength or share of sales may vary by region. (The Commission did note in its decision that Oracle had originally argued in an oral hearing that the geographic market was EEA-wide, whereas in the US trial it argued that the geographic market was global.)

Theories of consumer-harm anti-competitive effects

Under a mainly unilateral effects analysis, the DoJ complaint alleged that "the markets for high function HRM and FMS software are highly concentrated and the proposed purchase of PeopleSoft by Oracle would substantially increase concentration. The proposed purchase of PeopleSoft would reduce from three-to-two the number of firms that compete in the development and sale of these products." (See US DoJ First Amended Complaint, at 27.) In the course of its proceedings, the Commission argued that the transaction could lead to both unilateral effects and coordinated effects—where the three-to-two resulting duopoly could successfully coordinate, with no viable outsiders able to destabilise such a duopoly. Other theories of competitive harm were examined. The DoJ did not directly allege or present evidence at trial regarding coordinated effects, but did offer argument in a post-trial brief suggesting that it was plausible for a post-merger Oracle and SAP to tacitly collude to allocate markets along industry sectors. Similarly, the Commission considered possible vertical effects, but these were not determinative in its final decision.

The DoJ presented empirical economic analysis to support its position that the acquisition would result in higher prices for customers. Preston McAfee, the DoJ's economic expert, presented evidence on 25 specific competitions where the presence of PeopleSoft caused Oracle to offer greater discounts. Regression analysis confirmed these results. In addition, McAfee presented an auction model predicting higher post-acquisition prices. To counter these results, Oracle's expert Jerry Hausman took issue with McAfee's model specification, particularly the incremental discounts from list price calculations. Oracle also challenged the use of auction theory as the basis for the simulation model.

The benefit of additional bid data and the trial court deliberations allowed the Commission to conduct more robust econometric analyses demonstrating that the number and identity of the bidders did not systematically affect the discounts offered by Oracle. The Commission also used an auction model to simulate the effect of the merger, which allowed for uncertainty about the buyers' valuation of the alternative solutions. The model predicted not only substantial price increases due to the reduction

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of bidders from three to two, but also tried to estimate the effect of the merger on consumer surplus. The Commission submits that the use of simulation models depends critically on the ability of the model to adequately capture the fundamental mechanisms that drive the behaviour of the different market participants. However, it maintains that such necessary simplifying assumptions are not fatal, as any economic model used in a prospective merger analysis is necessarily based on assumptions, and that models can provide a high degree of transparency of the underlying assumptions and logical consistency in the model framework. Therefore, the Commission maintains that merger simulation remains a useful tool.

In its final evaluation of the bidding data, the Commission determined that the absence of a significant, appreciable effect of the number and identity of the final round bidders in the bidding data regressions did not enable it to show anti-competitive effects from the merger. However, this result was not taken as proof that the merger would not have harmful effects on customers. In addition to these empirical results, the Commission based its decision on the broader set of competitor and customer questionnaire responses, and the large body of documentary and US trial court evidence.

The US court found that the DoJ had failed to establish that the merged firm could exercise market power and thus, that the merger would not substantially lessen competition. The Commission also cleared the Oracle/PeopleSoft merger without conditions. A systematic review of the development of the economic evidence developed by the Commission suggests that although it benefited from the parallel US investigation, it conducted an independent merger investigation appropriately reflective of the EU market context.

Sony/BMG

In January 2004, Sony and Bertelsmann notified the competition authorities of their plan to create a full-function joint venture (SonyBMG) for their global recorded music business. This merger was investigated by both the US and EU, but resulted in much less transparency about the parallel processes than in the Oracle/PeopleSoft case described above. The FTC opened an investigation in 2004, but produced no published account of its reasoning or proceedings before closing its inquiry without taking any enforcement action.

In its initial review, the Commission solicited responses from customers and other competitors and provisionally concluded that the national markets for recorded music are dominated by five global record companies (the so-called 'majors') including Sony Music, BMG, Universal Music Group, Warner Music Group and EMI, which jointly have market shares between 72 per cent and 93 per cent in the European Economic Area (EEA) countries. Universal is the largest player and the combined SonyBMG is of approximately equal size.

Based on this initial investigation, the Commission issued a Statement of Objections and requested detailed transactions data from the five majors going back several years from all EEA markets. The empirical analysis and interpretation of this economic evidence formed the basis of its ultimate decision to allow the joint venture to proceed.

The focus of the Commission's investigation was the effect of the joint venture on the market for recorded music, which constitutes the largest part of the decision, but the decision also dealt with effects on upstream and downstream markets (music publishing and online distribution), on which SonyBMG would not be active itself but which could be affected by the joint venture.

Product market definition

The Commission chose a broad approach towards the product market definition and decided that the relevant market for recorded music in general was the appropriate market within which to evaluate this transaction, without seeing a need to define narrower markets based on genres or categories of recorded music (such as singles, albums or compilations). The Commission did not follow the parties' arguments that the online distribution of music was part of the market for recorded music but instead found the markets for the distribution of physical media and the online distribution of music to be distinct markets. Among the reasons for this distinction was that online music sales were characterised by different demand, namely for individual tracks (songs) and not for entire albums, and differences in the control that suppliers have over the use of the product after it is purchased by the consumer (the so-called digital rights management for online music). On the supply side, online and physical distribution of music were found to be entirely different. The Commission furthermore defined two separate markets for the wholesale licensing to online music services and the retail distribution from online music services to final consumers. Due to characteristics of the licensing structure, both markets were found to be national. The Commission defined the publishing of music (requiring mainly mechanical and performance rights for the distribution of music) as being an upstream market for the distribution of recorded and online music. Music publishing involves the authors and composers of music, whereas the recording business involves the singers and musicians. The Commission left the question open whether there could be separate markets for music publishing based on different types of rights and whether the geographic scope was national or wider.

Theories of consumer-harm anti-competitive effects

In its focus on the market for recorded music, the Commission's competitive impact analysis was based on a coordinated effects theory focused on the possible strengthening of a collective dominant position of the five major record companies maintained by tacit collusion. The Commission had requested from the five majors large amounts of price and sales data for several years for all EEA markets; its analysis was however somewhat focused on the five largest countries, as the smaller countries showed a similar picture. (The Commission also examined a possible vertical foreclosure theory that Sony/BMG could foreclose competitors if Bertelsmann refused to let them advertise and promote their

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artists on TV and radio. The Commission found no evidence that the foreclosure of rival record companies would have been a profitable strategy for Bertelsmann.)

The Commission analysed whether the pricing data revealed a coordinated pricing policy among the majors. For that purpose, a subset of the data limited to the sales of the top 100 single album CDs (as opposed to single CDs, maxi CDs and albums with more than one CD) to the top 20 customers was used to compare average net wholesale prices between majors. The parties have criticised the Commission for using average prices, arguing that these could be affected by mere product mix changes. The Commission furthermore regarded the focus on the top 100 albums to be justified by the fact that these covered 70 per cent to 80 per cent of the major's total music sales and were thus considered representative.

The Commission examined three key metrics: (1) parallelism in average net prices; (2) likelihood of using list prices (published prices to dealers or PPDs) as focal points to coordinate net prices; and (3) whether the majors' discounts to significant customers were aligned and sufficiently transparent to be monitored by each other.

In all of the five countries, the Commission economists found that there was some degree of parallelism in the pattern of average net prices between the five majors. The price differences between the majors generally were found to be confined within a relatively narrow band.

An empirical economic analysis revealed that list prices were potential focal points, as the differences between the various PPDs of different majors were relatively close to one another and, even though each major had a high number of different list prices, a very small number of these accounted for the vast majority of sales. These prices were also found to be transparent as they can be gathered from the majors' catalogues.

The Commission did not find significant differences on the overall discount levels between Sony and BMG. On the individual customer level however, differences between the discounts granted by the two merging parties were found to be large enough to let the Commission conclude that there was no sufficient alignment in the discounts to establish existing coordinated behaviour.

The Commission went on to analyse whether the markets were characterised by features that made them conducive to collusion. Although the physical characteristics of CD albums and the way they are marketed are relatively homogeneous, their content was found to be rather heterogeneous, which makes tacit collusion more difficult.

The Commission acknowledged that the variety of list prices complicated monitoring, while at the same time finding that monitoring only a limited set of albums (the top 20 selling albums of each major) would allow the record companies to assess the pricing for about half of the total sales. The publication of weekly hit charts including sales of each album, the limited number of large customers and the frequent contacts between all majors' sales personnel and the wholesalers/retailers were found to be facilitating collusion. However, the difficulties in monitoring certain types of discounts were found to be substantial and no evidence could be established that the record companies had solved this coordination problem.

Next, the Commission investigated whether retaliation against deviators was feasible and whether evidence of past retaliation could be found. Three potential mechanisms were identified: (1) a return to competitive behaviour; (2) exclusion of a deviator from compilations; and (3) retaliation in different markets (publishing and online). However, no evidence could be established that any of these methods had been used in the past to punish a deviator or that explicit threats in that direction had been made.

Although the Commission contended that some degree of pricing parallelism had been found, no conclusive evidence could be established regarding the existence of a collective dominant position of the five majors in any of the EEA countries.

The market for online distribution of music is relatively recent and still small. The Commission found that the majors had a similar or even stronger position in the market for wholesale licences for online music than in the market for recorded music. Prices charged for licences to online music providers were in a limited range but different usage rights made a comparison difficult. The Commission found that the prices charged to online music providers did not reflect the cost savings that could be achieved in comparison to the distribution of physical music recordings, but concluded that there was not sufficient evidence for a finding of existing collective dominance or that collective dominance was likely to be created by the joint venture.

For these reasons, the Commission cleared the merger on 19 July 2004, without conditions or obligations. Impala, an organisation of several independent music companies, has recently challenged the clearance decision of the Commission before the CFI (Pending case T-464/04, see OJ C 096, 1 August 2005, p 46).

In the US, the FTC closed its investigation on 28 July 2004, nine days after the Commission decided to clear the joint venture. The parties presented empirical evidence on the distribution of wholesale pricing, price dispersion for same release, and an econometric analysis showing that wholesale prices could not be reliably predicted from retail price. An econometric analysis also was presented showing no causation between consolidation in the industry and higher prices. In a press release, the FTC stated that: "Throughout the course of their respective investigations, the FTC and the Commission Competition Directorate's staff consulted and cooperated with each other under the terms of their 1991 cooperation agreement and 2002 statement of Best Practices on Cooperation in Merger Investigations." Details concerning this cooperation are unfortunately not known.

* *The authors gratefully acknowledge Marc Pirrung's assistance in preparing the article.*

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Dr Manning has performed economic analysis for antitrust litigation involving monopolisation, attempted monopolisation, vertical restraints, tortious interference, and fraud. She has also provided estimated lost profit and restitution damages for plaintiffs and defendants in antitrust, going-concern, breach of contract disputes, Lanham Act trademark and false advertising disputes, and intellectual property litigation.

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Ms Reed has helped European clients participate and expand in US and European markets and has advised in the area of antitrust policy and compliance. She assisted in several European merger reviews both before the European Commission and national competition authorities including the recent UK Phase II investigation conducted by the Competition Commission into Carl Zeiss/Bio-Rad Laboratories, which resulted in an unconditional clearance.

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