

Entry analysis in merger investigations

ICN Merger Working Group Workshop

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Note: The views expressed are those of the speakers and do not necessarily represent the views of the CMA

Entry analysis is important because...

- Prospect of entry into the relevant market will alleviate competitive concerns raised by a merger, but only if such entry will deter or counteract the competitive effects of concern so the merger will not substantially harm customers

Entry analysis can show...

- Undermine unilateral effects
- Disrupt coordination
- Constraint from potential competition
- Merger may increase barriers to entry

Two key types of entry considered in different ways

Rapid entrants

- Firms that are not current producers in the market, but would likely provide rapid supply responses in the event of a SSNIP without incurring significant sunk costs
- Considered in the analysis of firms that participate in the relevant market – often called supply-side substitution

Slower entrants

- Firms that would likely enter more slowly in response to adverse competitive effects, or that would require significant sunk costs to enter
- Considered in the entry analysis

Consider the various steps needed to produce and sell in the market

- Planning, design, and management
- Permitting, licensing, or other approvals
- Construction, debugging, and operation of production facilities
- Promotion, marketing, distribution, testing, and qualification requirements

Consider history of entry (both successful and unsuccessful attempts)

- Identify the elements of a practical entry (e.g., minimum viable scale, entry barriers, costs)
- Determine how past attempts fared, and why they succeeded or failed
- Past successful entry alone, however, does not necessarily end the inquiry

Questions to consider when assessing the impact of potential entrants (a three-part test)

- **Timeliness:** How soon could the entrant start selling the product?
- **Likelihood:** What are the chances that the firm would be profitable enough to pursue?
- **Sufficiency:** Would the competitive impact of the entrant be significant enough to offset the anticompetitive impact of the merger?

Note: There is no “right” order to carry out the three parts

Timely?

The timeliness test assesses whether entry will be rapid enough to deter or counteract the competitive concerns raised by the merger

Measurement of time period

- Measured from initial planning to significant market impact

Not concerned with short-term, interim supra-competitive prices

- Focus on whether entry will be rapid enough to make unprofitable overall the actions caused by the competitive effects of the merger, even though those actions may be profitable in the short term

The likelihood test assesses whether entry would be profitable

Issue is not merely whether entry could occur, but whether it would occur (i.e., is there sufficient profit incentive to induce entry?)

Profitability measured taking into account

- Output level the entrant is likely to obtain
- Price the entrant would likely obtain in the post-merger market (new entry may push price down to premerger level or lower)
- Cost per unit, which may depend on entrant's scale of operation

Sufficient?

- **The weight on both sides of the scales matters**
 - Big SLC → stronger evidence on entry required
 - Small scale entry may not offset the scale of SLC (think market shares!)
 - Geographic scope?
- **However even small scale entry may be sufficient**
 - For example with homogenous products
 - Merged entity would lose market share quickly if it raised prices
- **Product differentiation matters**
 - Move away from market shares
 - Think about closeness of competition
- **Diversion?**

The threat of potential entry

- **Incumbents may be constrained by threat of potential competition**
- **Potential competitor may be:**
 - Actual potential competitor which is likely to enter the market and has advanced plans for entry
 - Perceived potential competitor which is perceived by incumbents as likely to enter and may constrain incumbent behaviour
- **Merger may remove potential competitor or make it more difficult for a third party potential competitor to enter**
- **Entry barriers form an important part of the analysis**

Structural barriers to entry: conditions outside the control of the firms in the market

- Government regulations and policies
- Reputation or consumer goodwill
- Dominant firm controls key intellectual property
- Sunk costs – consider barriers to exit

Behavioral barriers to entry: conditions within the control of firms in the market

- Vertical restraints
- History of predatory pricing
- Excess capacity

A relevant UK example

- **Barr / Britvic (2013)**

- Large soft drinks manufacturers behind brands such as J2O, Tango, Robinson and IRN-Bru
- CMA looked at the cost of entry for a completely new product / brand, as well as for a new pack format for an existing product or a similar product to one produced by a competitor
- CMA concluded it unlikely that the threat of a new entry of a product that would compete with IRN-Bru would act as a significant constrain on the merger entity
- However, CMA concluded that the merger would not be likely to give rise to an SLC in any market in the UK
- Note: the merger did not go ahead in the end with Britvic rejecting AG Barr's offer

ICN Recommended Practices for Merger Analysis

Section VII. Entry & Expansion

- The assessment of firm entry and/or expansion by existing competitors should be an integral part of the analysis of whether a merger is likely to harm competition significantly (e.g., the merged firm could raise prices or reduce output, quality, or innovation).
- In assessing whether entry and/or expansion would effectively constrain the merged entity, competition agencies should consider whether entry and/or expansion would be: (a) likely; (b) timely; and, (c) sufficient in nature, scale and scope.

Practical techniques for evaluating entry

- **Historical evidence**
- **Third party views**
- **Modelling entry strategies**
- **Sunk costs**
- **Profitability**

Practical techniques for evaluating entry

- **Historical evidence**
 - Useful to have real examples of entry, but:
 - Might there have been developments which changed entry barriers since previous entry occurred?
 - Could low entry/exit simply reflect existing firms actively competing?

Practical techniques for evaluating entry

- **Third party views**
 - May provide important evidence
 - Useful in corroborating entry cost figures with those of the parties
 - May suggest that entry is unlikely, even if entry barriers appear low
 - Issue of third parties attempting to frustrate the process

Practical techniques for evaluating entry

- **Modelling entry strategies**
 - Both main and third parties may provide useful accounts of the strategies that could be used by a potential entrant
 - In some cases the parties present formal economic models to assess the likelihood of entry

Practical techniques for evaluating entry

- **Sunk costs**
 - Costs that a firm cannot recover even if it leaves the market
 - Incumbents have sunk costs but entrants have not
 - A reliable measure of sunk costs could show the risk of entry
 - How to measure?
 - How to place sunk costs in context?

Practical techniques for evaluating entry

- Profitability
 - Evidence of persistently high profits amongst incumbents may indicate that barriers to entry are high
 - May therefore examine profitability as part of the assessment of entry barriers
 - ***Be careful***
 - Relationship between long-run profitability and entry barriers may not hold.
 - Low profits may also conceal barriers to entry because of rent extraction. If an input is scarce, the price may be so high as to reduce the profitability of downstream users
 - Problems with the valuation of assets for profitability analysis

Final slide – a way forward

- **Identify recent entry efforts (successful and unsuccessful)**
- **Identify potential barriers to entry (structural and behavioral)**
- **Apply the three-part test:**
 - **Timeliness:** Can entry occur relatively quickly?
 - **Likelihood:** Is new entry likely to be profitable?
 - **Sufficiency:** Will new entry be sufficient in character and magnitude
 - to deter or counteract the competitive effects of concern?
- **Entry will be considered easy if, and only if, it passes all three tests**