



CMA consultation on the Revised Merger Assessment Guidelines

Response of KPMG's Economics practice

January 2021

1 Introduction

- 1.1 We welcome the opportunity to respond to the CMA's consultation on the Draft Revised Merger Assessment Guidelines ('Draft Revised Guidelines').¹ We advise clients on a range of competition economics matters, including in the context of merger investigations in the UK and worldwide. The opinions expressed in this response are our own, and do not necessarily align with those of our clients.
- 1.2 It has been ten years since the UK Merger Assessment Guidelines ('the Current Guidelines')² were last revised, and many parts of the Draft Revised Guidelines are a positive change. For example, we welcome the additional clarifications to reflect recent case experience and Competition Appeal Tribunal ('CAT') judgements, as well as new types of market structure that have grown in prominence since the Current Guidelines were last revised (such as two-sided platforms).
- 1.3 As part of its consultation on the Draft Revised Guidelines, the CMA has set out five questions to be considered.³ In the rest of this document we provide our response to those questions. We first look at the substantive issues covered in the Draft Revised Guidelines, specifically market definition, buyer power, dynamic markets and innovation, and countervailing factors (entry and expansion and efficiencies). We then consider the underlying evidence used as part of the CMA's merger assessment, in particular internal documents, deal valuation materials and profit margins. Our key points are summarised in the box below.
- 1.4 Before setting out our key points, we first note two relevant points of context. First, the CMA's Digital Markets Taskforce has recently published its advice to government on the design and implementation of a competition regime for digital markets.⁴ This includes a recommendation for a distinct merger control regime for firms with designated Strategic Market Status. As this process is distinct from the present consultation, we have not commented on these recommendations in detail below. We have previously responded to the CMA's consultation on digital mergers and have reflected these points where relevant.⁵
- 1.5 Second, the Draft Revised Guidelines state that a common theme from the recent academic literature and expert reports is that there has been under-enforcement by competition authorities, particularly in relation to digital markets.⁶ While certain reports have highlighted the risk and concerns of under-enforcement, to our knowledge there has not been significant evidence produced on the extent or nature of any such under-enforcement in the UK. We would therefore be concerned by any change to merger policy that aims to increase intervention or adverse findings, without due consideration for the potential errors in assessment that this could generate. We also note that the CMA appears to have increased its level of enforcement in recent years,⁷ which shows that the rate of enforcement can change over time, highlighting the need to focus on the specific nature of any underenforcement as opposed to the rate of adverse decisions per se.

¹ Draft revised guidance: Merger assessment guidelines ('Draft Revised Guidelines'), CMA, November 2020.

² CC2 Revised / OFT1254: Merger Assessment Guidelines ('Current Guidelines'), CC/OFT, September 2010.

³ Consultation document: Merger assessment guidelines ('Revised Guidelines Consultation'), section 3, CMA, November 2020.

⁴ A new pro-competition regime for digital markets: Advice of the Digital Markets Taskforce, CMA, December 2020.

⁵ [CMA Call for Information on Digital Mergers: Response of KPMG's Economics Practice](#), KPMG, July 2019.

⁶ Paragraph 1.7 of the Draft Revised Guidelines.

⁷ For example, the CMA's merger inquiry outcome statistics, December 2020 update, indicate that in recent years there has been an increase in the proportion of Phase 2 cases that were prohibited or abandoned.

Summary of our response to the Draft Revised Guidelines

Substantive issues addressed in the Draft Revised Guidelines

Market definition: We consider that market definition remains an important initial step in the overall assessment, facilitating a structured analysis of product differentiation and substitutability. Geographic market definition is likely to become more important as the CMA begins to assess cases that were previously the domain of the European Commission.

Buyer power: We agree that buyer power should be considered within the competitive assessment. However, the Draft Revised Guidelines focus only on buyer power which results in new entry. Particularly in markets characterised by bilateral negotiations, it is necessary to consider how prices and other factors are determined by the relative bargaining power of buyers and sellers, in order to properly analyse competitive effects.

Dynamic markets and innovation: The Draft Revised Guidelines should explain that when considering firms' ability and incentives to innovate, the CMA will consider the process through which innovation takes place, and avoid applying any kind of one-size fits all approach where innovation is treated analogously to prices.

Entry and expansion: The Draft Revised Guidelines continue to view entry and expansion as a countervailing factor, against what would otherwise be an SLC finding. We consider that, instead, assessment of the underlying conditions for entry and expansion should form part of the competitive assessment. Evidence from the KPMG ex post evaluation study could be used to provide guidance on the sorts of evidence and factors that are likely to be most informative when considering entry and expansion.

Efficiencies: It can be particularly challenging for parties to demonstrate 'dynamic' efficiencies, such as an increase in R&D productivity. In our view, the Draft Revised Guidelines should provide further clarity on the type of evidence that would be required to adequately demonstrate such efficiencies, as well as the CMA's approach to merger-specificity. This would help to ensure that the CMA takes a balanced approach to the impact of mergers on outcomes such as innovation.

Evidence

Internal documents: The CMA has increasingly analysed internal documents and other qualitative evidence, particularly in dynamic and 'nascent' markets. It is crucial that all such evidence is considered within the context of an overarching economic framework, to ensure that the analysis focuses directly on the incentives and constraints of market participants. The Draft Revised Guidelines should set out further detail on the CMA's use and interpretation of internal documents, as well as their potential limitations.

Deal valuation materials: Whilst transaction values in principle contain relevant information, as a standalone piece of evidence we believe that they are unlikely to be informative of whether an acquisition is likely to lead to a reduction of potential competition. There are many important factors that determine transaction value, such that it is informative of potential competition only to the extent that these factors can be appropriately controlled for.

Profit margins: The Draft Revised Guidelines indicate that profit margins can be informative in both horizontal and non-horizontal contexts. In our view, greater clarity could be provided on precisely which margin should be used in each context. We consider that a move towards incremental (rather than variable) margins would allow for more targeted information requests, and greater precision in the analysis.

2 Substantive issues addressed in the Draft Revised Guidelines

Market definition

- 2.1 The role of market definition has been reduced in the Draft Revised Guidelines and, to reflect this change in approach, it has been moved to the end of the Draft Revised Guidelines. Market definition is now viewed by the CMA as an analytical tool to be used as part of the assessment of competitive effects and is no longer considered a separate exercise.⁸ In reaching this conclusion, the CMA refers to the significant degree of overlap in the underlying evidence used for market definition and the competitive assessment, and accordingly, considers that there is only a limited incremental value in performing a formal market definition exercise.⁹
- 2.2 In our view, the CMA is right to conclude that market definition should not be viewed as an end in itself, and that it is important to consider the full range of competitive constraints within the competitive assessment.¹⁰ However, we consider that both in principle and in practice, market definition remains an important initial step in the overall analysis. In particular, the market definition framework facilitates a structured assessment of the key dimensions over which products are differentiated, as well as the extent of any product differentiation and therefore the extent to which different products are substitutes for one another.
- 2.3 In our view, it becomes more difficult to assess the key issues on closeness of competition without having first undertaken this exercise. Regardless of whether such an exercise is undertaken as a separate exercise or as part of the competitive assessment, it is important for it to be conducted and presented as a distinct step in the analysis. For example, the Draft Revised Guidelines state that market definition can be more helpful in cases where structural indicators of competition are more important, such as where products are homogeneous.¹¹ This in our view is an argument for conducting a separate market definition step in the assessment, as that is precisely what is needed in order to assess whether and to what extent products are homogeneous and therefore what evidence might be more relevant to the case at hand.
- 2.4 Further, the Draft Revised Guidelines draw on previous cases investigated by the CMA, but these do not reveal the added complexities found in international mergers which were previously the exclusive domain of the European Commission (EC). The EC market definition guidelines are currently under review, but the issue of geographic market definition has been a crucial stepping-stone to understanding the competitive effects of, for example, steel mergers or high-speed trains. We therefore believe that geographic market definition is an important first step, as it enables a structured assessment of the relevant direct competitor set and is consistent with international best practice.
- 2.5 The CMA is used to identifying local markets (and local competitors) within the UK, but it will now have to look beyond UK political boundaries to some markets which operate at a wider European level and where shares of UK supply may be of limited relevance. Preliminary market definition would help a resource-constrained CMA to identify mergers whose appraisal should be more in line with that of other investigating authorities, as distinct from those for which it is particularly important to provide an independent UK analysis.

⁸ See paragraph 9.1 of the Draft Revised Guidelines.

⁹ See paragraph 1.52 of the Draft Revised Merger Assessment Guidelines: Consultation Document.

¹⁰ Paragraph 9.4 of the Draft Revised Guidelines.

¹¹ Paragraph 9.3 of the Draft Revised Guidelines.

Buyer power

- 2.6 Another notable change in the Draft Revised Guidelines is the treatment of buyer power. The section on countervailing buyer power has been removed entirely. Instead, buyer power is analysed as part of the competitive assessment in the Draft Revised Guidelines.¹²
- 2.7 We agree that buyer power should be considered in the competitive assessment, and with the view expressed by the CMA that market power and buyer power are two sides of the same coin. However, the Draft Revised Guidelines focus only on buyer power which results in new entry, with the CMA in our view incorrectly omitting other relevant considerations.¹³ In doing so the CMA effectively, despite incorporating buyer power in its competitive assessment, still treats it purely as a “countervailing factor” which may compensate for an SLC that is otherwise expected to follow from a reduction in the alternatives available to a buyer.
- 2.8 This approach, we suggest, would be incorrect. The more general point, that in our view should be explicitly recognised in the Draft Revised Guidelines, is that where the terms of trade in a market are determined via bilateral negotiations, the appropriate framework for conducting a competitive assessment is the Bargaining Framework.¹⁴ This is already consistent with CMA practice, and allows the CMA to consider *the extent to which* prices and other factors depend on the buyer being able to switch between the merging parties. The elimination of an alternative supplier may well result in buyer power being worsened to the extent that prices increase, but this cannot be presumed to be the case (as in paragraph 4.19 of the Draft Revised Guidelines) in the absence of sponsored entry.
- 2.9 Instead, using the Bargaining Framework, the outside option of both the buyer *and* seller need to be considered together to assess competitive outcomes (both pre- and post-merger). Assessing the value of the seller's outside option includes consideration of issues such as the number of alternative buyers and their shares of supply; the relative volumes sold to each buyer; the size, frequency and duration of contracts; and the supplier's cost structure (e.g. a seller with a high proportion of fixed costs may face particular financial challenges from the loss of a contract, weakening its outside option).
- 2.10 We also note that in markets where buyers have strong bargaining power, they can squeeze the margins earned by sellers. Mergers between suppliers can sometimes be a way to address this, either through an increase in market power (to which the CMA should be vigilant) or through cost efficiencies (which are pro-competitive). The Bargaining Framework can help the CMA to distinguish between these two scenarios.
- 2.11 Examples in which the Bargaining Framework has been used to analyse competitive outcomes in markets characterised by bilateral negotiations include:
- The Private Healthcare Market Investigation: The CMA applied the Bargaining Framework to assess the terms of trade reached in bilateral negotiations between hospital operators and insurers. The CMA found that bargaining outcomes depended on the outside option of *both* suppliers (hospital operators) and customers (insurers).¹⁵ It also considered the extent to which customers could create alternative products or *contracting strategies* to increase their outside options, i.e. customers could pursue strategies to exercise buyer power independently of new entry.¹⁶
 - *Cott Beverages Limited / Macaw (Holdings) Limited*: The Competition Commission (CC) analysed the relative bargaining power of suppliers and retailers (buyers) of soft drink products and packaging. It found that despite relatively high levels of supplier concentration, retailers benefitted

¹² Paragraph 4.18-4.19 of the Draft Revised Guidelines.

¹³ Paragraph 4.19 of the Draft Revised Guidelines.

¹⁴ See Sutton (1986) for an overview of the fundamental principles of the bargaining framework, namely the role of outside options on the negotiated outcome (Sutton, J., “Non-cooperative bargaining theory: an introduction”, *Review of Economic Studies*, pp. 709-724).

¹⁵ Private Healthcare Market Investigation, Remittal Final Report, paragraph 6.9.

¹⁶ Private Healthcare Market Investigation, Remittal Final Report, paragraph 11.21.

from considerable bargaining power, and would continue to do so post-merger, despite significant increases in concentration.¹⁷ The CC found that this buyer power derived from several factors, including the ability to switch easily between suppliers, the flexibility of retailers' buying strategies (including the ability to determine the mechanism, size and composition of tenders), and the fact that the loss of a supply agreement could have a significant impact on a supplier's financial performance (due to the fixed costs incurred by suppliers).¹⁸

- *Korsnäs / AssiDomän Cartonboard*: The EC found that Tetra Pak was an important customer for suppliers of liquid packaging board, accounting for a large share of their sales and profitability.¹⁹ In contrast, Tetra Pak was less dependent on any given supplier, and would be capable of exercising buyer power post-merger by playing-off the merged entity against StoraEnso, an existing supplier. The EC therefore considered that Tetra Pak exercised considerable buyer power, independently of any considerations over entry. In fact, in this decision the EC found that the merger could enhance buyer power, as the merged firm would be a more credible alternative to StoraEnso due to its improved product portfolio.²⁰

Dynamic markets and innovation

- 2.12 An area in which the Draft Revised Guidelines provide additional detail is in relation to the CMA's approach to dynamic markets and innovation. This is covered within Section 5 of the Draft Revised Guidelines, which distinguishes between two aspects of 'potential competition'. The first, termed 'future competition',²¹ involves a scenario where one (or both) of the merging parties is a potential entrant to a market currently served by the other. The second, termed 'dynamic competition',²² relates to a broader set of circumstances in which investment and innovation represent an important part of the competitive process.²³
- 2.13 As we have noted elsewhere,²⁴ competition authorities have become increasingly interested in how to assess competition in dynamic markets. We therefore welcome additional clarity on the CMA's approach to these issues. We also agree that there is a conceptual distinction between (i) circumstances in which there is a relatively narrow consideration of products that are in very late stages of development and are soon to be launched – i.e. what the CMA terms 'future competition' – and (ii) circumstances in which there is ongoing innovation by market participants and/or frequent changes to market structure – i.e. what the CMA terms 'dynamic competition'.
- 2.14 In the case of 'future competition', we agree with the statement at paragraph 5.14 that the analysis is similar to the case where the parties are existing suppliers, albeit that the assessment must consider competitive conditions in the near future rather than the present. A more complex set of issues arises, however, in the assessment of 'dynamic competition'. The Draft Revised Guidelines indicate that a merger may reduce dynamic competition because, absent the merger, the parties have an incentive to innovate to protect future sales from being captured by the other merging party; post-merger, this incentive is reduced because the merged entity recaptures such sales – i.e. the merged entity 'internalises' the negative impact of each firm on the other's sales.²⁵

¹⁷ *Cott Beverages Ltd and Macaw (Holdings) Ltd merger inquiry*, Final Report, Competition Commission.

¹⁸ Paragraphs 5.18 to 5.33, *Cott Beverages Ltd and Macaw (Holdings) Ltd merger inquiry*, Final Report, Competition Commission.

¹⁹ Paragraph 46, Case No COMP/M.4057 - *Korsnäs / AssiDomän Cartonboard*, European Commission, 12 May 2006.

²⁰ Paragraph 53, Case No COMP/M.4057 - *Korsnäs / AssiDomän Cartonboard*, European Commission, 12 May 2006.

²¹ See paragraphs 5.7-5.16 of the Draft Revised Guidelines

²² See paragraphs 5.17-5.24 of the Draft Revised Guidelines

²³ Paragraph 5.18 of the Draft Revised Guidelines

²⁴ See, for example, our recent article entitled [Merger Assessment in Dynamic Markets: Reflections on Three Recent Vertical Cases at the CMA](#).

²⁵ See paragraphs 5.18 and 5.19 of the Draft Revised Guidelines. We note that paragraph 5.19 refers only to competitive interactions between "an existing supplier and a potential entrant, or between two potential entrants". It is not clear why this paragraph excludes the case of two existing suppliers, whose competitive interactions are often the subject of assessment in dynamic markets.

- 2.15 In this sense, the Draft Revised Guidelines outline an approach to the assessment of innovation that is analogous to the unilateral effects framework applied, for example, to the assessment of prices.²⁶ In our view, however, the unilateral effects framework, as applied to prices, does not directly translate to the analysis of innovation. In particular, innovation (unlike price) is not a choice variable for the firm, but is rather an outcome of a complex process which in many cases represents an important cost for firms. Recognising this is important in correctly assessing plans to rationalise R&D processes post-merger for example. Furthermore, such processes can vary significantly across both industries and individual firms. In sectors such as pharmaceuticals and agrochemicals for example, innovation generally progresses along relatively well-defined lines of research that can take decades from initial product discovery to ultimate product launch. In other sectors, including many digital industries and service sectors, innovations are often developed during the normal course of business, e.g. with firms testing prototype products and iterations on subsets of customers in real time. The nature of these processes matters to identify the scope for efficiencies or pro-competitive rationales for a merger.
- 2.16 In our view, the Draft Revised Guidelines should therefore specify that the CMA will consider the process through which innovation takes place in the relevant market(s) under consideration, and avoid applying any kind of one-size fits all approach where innovation is treated analogously to prices. Understanding this process is critical, for example, in understanding the key drivers of innovation, the time period in which any impact of the merger might occur, the degree of certainty that can be placed on such impact, and the extent to which the market structure itself – including the prospect of new entry – could change over the innovation lifecycle. We also note that in some markets characterised by high levels of R&D, market structure is itself *determined* by the level of R&D spend, such that more competitive markets are also more concentrated. This means that measures of concentration in these markets may not be reliable indicators of market power pre- or post-merger. Adopting an approach that mirrors the assessment of price effects could, as a result, lead to errors in the assessment.

Countervailing factors

Entry and expansion

- 2.17 The Draft Revised Guidelines note that “entry and/or expansion preventing an SLC from arising would be rare.”²⁷ In this context, the CMA refers to an ex post evaluation of previous merger cases where evidence on entry or expansion formed part of the clearance decision, conducted by KPMG.
- 2.18 It is, however, important to understand the scope and context for this KPMG ex post evaluation (“KPMG study”).²⁸ First, the KPMG study focussed only on clearance decisions.²⁹ As such, the KPMG study was able to evaluate cases where evidence on entry and expansion had formed part of the basis for allowing a merger to proceed, but was not able to assess cases where the CMA may have over-enforced or under-predicted entry and expansion. Second, the cases reviewed in the KPMG study were eight cases, chosen in consultation with the CMA, from a longer list of cases itself drawn up by the CMA. These cases were not selected to be representative of the CMA (and Competition Commission / Office of Fair Trading) past decisions over entry and expansion.³⁰ We would therefore urge caution against using the KPMG study to support any general statement in the Draft Revised Guidelines that entry or expansion preventing an SLC will be rare.
- 2.19 Evidence from the KPMG ex post evaluation study could however be used to provide guidance on the sorts of evidence and factors that are likely to be most informative when considering entry and expansion. In particular, evidence from the KPMG ex post evaluation study suggests that the CMA has been most successful in its analysis of entry and expansion where it analysed underlying economic

²⁶ We note that this approach is also similar to that adopted by the European Commission to assess innovation, for example in *Dow/DuPont* and *Bayer/Monsanto*.

²⁷ Draft Revised Guidelines, paragraph 8.26.

²⁸ Entry and expansion in UK merger cases: An ex-post evaluation (‘KPMG Evaluation’), KPMG, April 2017.

²⁹ KPMG Evaluation, paragraph 3.

³⁰ KPMG Evaluation, paragraph 4.

factors which are likely to make entry more successful, such as costs of entry for firms operating in closely related markets, consumer preferences and uptake of new products, and the ease and frequency of product repositioning.³¹ Similarly, the study highlights the importance of regulatory barriers, including local regulation. We suggest that the Draft Revised Guidelines could usefully emphasise the importance of assessing these underlying economic features, over and above assessing specific entry plans of potential new entrants.

- 2.20 More generally, the Draft Revised Guidelines continue to view entry and expansion as a countervailing factor against what would otherwise be an SLC finding. We consider that, instead, assessment of the underlying conditions for entry and expansion should form part of the competitive assessment. The Draft Revised Guidelines indicate that analysis of entry and expansion in the competitive assessment will be limited to considering entry and expansion plans of rivals that will occur irrespective of the merger.³² However, the existence of economic conditions which would be likely to support successful entry (i.e. low barriers to entry and expansion), can also exert a competitive constraint on firms' behaviour in the absence of actual entry. The assessment of such issues should not therefore be decoupled from the competitive assessment. The discussion in paragraph 8.33 of the Draft Revised Guidelines on the categories for the circumstances for entry and expansion appears not to recognise this possibility, which seems to be an omission.

Efficiencies

- 2.21 As in the Current Guidelines, the Draft Revised Guidelines state that the burden of proof is on merging parties to demonstrate any efficiencies that might arise from the merger.³³ This is on the basis that most of the relevant evidence is held by the merging parties themselves. When considering *static* efficiencies, such as a reduction in marginal costs, we agree that this is typically a reasonable assumption. Firms (or their advisors) undertake detailed commercial due diligence for example, which generally includes an assessment of areas where cost synergies can arise. In many cases these synergies can also be achieved relatively quickly, allowing the CMA to have a degree of confidence in the potential cost savings arising from the deal, the extent of pass-through and likely timings.
- 2.22 When considering *dynamic* efficiencies however, such as increased R&D productivity, it is much less clear that the merging parties have access to the necessary information to adequately demonstrate efficiencies. Indeed, as recognised in the Draft Revised Guidelines, in dynamic markets the CMA is often concerned with uncertain, long-term effects. In this context, it can be extremely challenging for merging parties to adequately demonstrate that efficiencies are timely, likely and sufficient, or that they are merger specific. This does not necessarily mean that such efficiencies are not potentially material, however. Indeed, research has shown that firms vary significantly in their R&D productivity, that research spillovers are quantitatively important, and that mergers often have a positive impact on innovation.³⁴
- 2.23 In our view, it would therefore be helpful for the Draft Revised Guidelines to distinguish between static and dynamic efficiencies, and to provide further clarity as to the type of evidence that would be required to adequately demonstrate dynamic efficiencies. With regards to merger-specificity in particular, it is important that the CMA investigates whether alternative approaches (such as research joint ventures) are practical, would result in the same level of benefits, and maintain competitive tension between the relevant firms in the market(s) under investigation. This approach would help to ensure that the CMA takes a balanced view of the potential impact of mergers on innovation and other important market outcomes.

³¹ KPMG Evaluation, Section 11.2.

³² Paragraph 8.25 of the Draft Revised Guidelines

³³ Paragraph 8.6 of the Draft Revised Guidelines

³⁴ See, for example Bena, J. & Li, K. (2014) 'Corporate innovations and mergers and acquisitions', *The Journal of Finance*, 69 (5); Bloom, N., Schankerman, M. & Van Reenen, J. (2013) 'Identifying technology spillovers and product market rivalry', *Econometrica*, 81(4); and Denicolo, V. & Polo, M. (2018) 'Duplicative research, mergers and innovation', *Economics Letters* 166.

3 Evidence

Internal documents

- 3.1 The Draft Revised Guidelines note that the CMA has increasingly analysed merging parties' internal documents, as well as evidence on deal valuation (discussed below), as part of its merger investigations.³⁵ The Draft Revised Guidelines also state that particular weight might be placed on internal documents in dynamic and nascent markets, as the overall evidence base available to the CMA might be more limited.³⁶
- 3.2 We agree with the general statement in paragraph 2.27 that even in dynamic and nascent markets, internal documents should be considered alongside other evidence such as the characteristics of the parties' products, and the expansion plans of market participants. More generally, in our view it is crucial that all such qualitative evidence is considered within the context of an overarching economic framework, to ensure that the analysis focuses directly on the incentives and constraints of market participants. Qualitative evidence should therefore be used primarily to inform the parameters of the overarching framework, as would be the case for quantitative evidence, with much more limited weight placed (for example) on general statements and views.³⁷
- 3.3 In this context, we are concerned for example with the statement in the Draft Revised Guidelines regarding vertical mergers that "if the merger firms' internal documents show that it would be strategically beneficial to stop supplying rivals, it may not be necessary to try to infer their behaviour from their financial incentives".³⁸ In our view, any assessment of the incentives to foreclose must necessarily consider the parties' financial – or, more specifically, economic – incentives to do so. In certain contexts, it may be that internal documents are informative of these economic incentives. Even so, it is crucial to test the evidentiary value of such documents, for example by interrogating who produced them, for whom, and on the basis of what evidence.
- 3.4 The overarching economic framework is also important in order to interpret accurately internal documents and other qualitative evidence. For example, even if an internal document identifies the other merging party as a competitor, it is not clear without further analysis what this means in practice for the impact of the merger on market outcomes – such as the likely magnitude and timing of any impact. In this respect, we note that the Draft Revised Guidelines state (in relation to efficiencies) that firms often do not fully realise expected synergies from their mergers.³⁹ To the extent that this is true, it must also apply to internal documents more generally. That is, internal documents may not be fully reflective of market conditions, or accurate predictors of post-merger outcomes. In our view, it would therefore be helpful if the Draft Revised Guidelines set out some further details on the CMA's use and interpretation of internal documents, as well as their potential limitations.

Deal valuation materials

- 3.5 The Draft Revised Guidelines specifically highlight the increasing role of deal valuation materials as evidence, for example to assess potential competition, deal rationale and synergies.⁴⁰ As noted in our response to the CMA's call for information on digital mergers, while the value of a transaction in principle contains some relevant information, as a standalone piece of evidence we believe that transaction values – or their ratios to the turnover, profitability or market value of a target – are unlikely to be informative of whether an acquisition is likely to lead to an elimination of potential competition.⁴¹

³⁵ Paragraph 2.23 of the Draft Revised Guidelines

³⁶ Paragraph 2.27 of the Draft Revised Guidelines

³⁷ We have discussed the use and interpretation of internal documents in our recent article entitled [Merger Assessment in Dynamic Markets: Reflections on Three Recent Vertical Cases at the CMA](#).

³⁸ Paragraph 7.18 (a) of the Draft Revised Guidelines.

³⁹ Paragraph 8.6 of the Draft Revised Guidelines.

⁴⁰ Paragraph 2.23 of the Draft Revised Guidelines.

⁴¹ See paragraphs 4.6 – 4.7 of the [CMA Call for Information on Digital Mergers: Response of KPMG's Economics Practice](#).

- 3.6 First, turnover or profitability may be an unreliable benchmark. In the case of fast-growing companies for example, run-rates may be more relevant than historical performance over a longer period and firm values may reflect relatively higher growth-adjusted valuation multiples. Further, in markets characterised by strong network effects, young and fast-growing companies may endure a period of very low or negative profits as they increase scale. Current turnover would be a poor indicator of future revenues and profits in this case. Future profitability may better be assessed by considering, for example, the size of customer bases, customer product usage (e.g. time spent on platforms), the total addressable market or other (non-financial) measures.
- 3.7 Second, market value is often difficult to determine, and even if it is known, there may be competing reasons behind relatively “high” transaction values. Transaction values are a function of a number of factors such as the potential to generate cost synergies and/or quality improvements, the value associated with key individuals, and/or the risk tolerance of the acquirer; a reduction in future competition may be only one such potential factor.
- 3.8 In cases where transaction values appear to be “high”, we therefore suggest that the CMA looks to further evidence in order to understand the determinants of (and assumptions behind) the transaction value, such as due diligence conducted by the acquirer. Additional factors such as the structure of the competitive process (e.g. the number of bidders or post-agreement negotiations) can also influence the transaction value and should be considered if the CMA is to assess transaction values in detail.

Profit margins

- 3.9 The Draft Revised Guidelines state that horizontal unilateral effects are more likely where variable profit margins are high, because in this case the “value of sales recaptured by the merged entity will be greater, making it less costly to raise prices or worsen non-price aspects of the competitive offering”.⁴² We agree that in certain contexts, profit margins can be a valuable source of evidence for analysing unilateral effects; both in isolation and as part of upward pricing pressure tests such as GUPPI.
- 3.10 In our view however, the Draft Revised Guidelines could be improved through more careful use of cost and margin terminology. In particular, the purpose of the margin in this context is to estimate the value of sales that may be recaptured by the merged entity. The value of these recaptured sales is a function of the pre-merger price, less the incremental costs incurred as a result of the increase in sales volumes. The appropriate margin to use is therefore the *incremental* margin, rather than the *variable* margin.
- 3.11 The use of the more precise “incremental margin” terminology would encourage both the volume increment and time period to be considered explicitly when calculating margins. For example, variable margins are often interpreted as price minus short-run marginal costs. This calculation is unlikely to accurately estimate the value of recaptured sales however, because by construction it estimates the value of only a short-lived and very small (one unit) change in sales volumes. In practice, where the volume of recaptured sales is larger and/or sustained over time, additional costs may be incurred by the firm, such that the true value of recaptured sales will often be smaller than suggested by price less short-run marginal costs.
- 3.12 The use of incremental margins would also enable the CMA to ask more targeted questions in information requests. For example, parties could be asked for the incremental margin on additional sales, should they experience a sustained increase in volumes of (say) 5-10 percent. This approach would therefore provide clarity to merging parties responding to information requests and ensure that the most accurate information is used in the CMA’s analysis. We also note that this approach would be consistent with that taken in the US Horizontal Merger Guidelines, which state:⁴³

“Incremental cost depends on the relevant increment in output as well as on the time period involved, and in the case of large increments and sustained changes in output it may include some costs that would be

⁴² Draft Revised Guidelines, paragraph 4.11.

⁴³ Horizontal merger guidelines, 21, Section 6.1, US Department of Justice and the Federal Trade of Commission, August 2010.

fixed for smaller increments of output or shorter time periods... For this purpose, incremental cost is measured over the change in output that would be caused by the price change considered.”

- 3.13 In practice, margins are used in a variety of contexts in merger cases – when considering both horizontal and non-horizontal effects – and it is therefore important to ensure that the most accurate figures are used in the analysis. We note that the use of incremental margins would be consistent with the approach taken in the United States (above), and that the EC has also moved in this direction.⁴⁴
- 3.14 Finally, given the important role of GUPPI (and related pricing pressure indices) in the CMA's decision making, it is surprising that this is not mentioned specifically in the Draft Revised Guidelines.⁴⁵ In our view, it would be helpful for the CMA to set out when and how tools such as GUPPI will be used, for example in 'bricks and mortar' retail mergers, and where they are of more limited application.

⁴⁴ See the upward pricing pressure analysis in Case No COMP/M.7018: Telefonica Deutschland / E-Plus, European Commission, July 2014.

⁴⁵ Pricing pressure indices are mentioned in footnote 77 of the Draft Revised Guidelines but are not covered in detail in the main text.

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

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