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17 April 2004

The Honourable Sin Chung Kai
Legislative Councilor
Chairman, Panel on Information, Technology and Broadcasting
Legislative Council
c/o 601, 6th Floor
Citibank Tower
3 Garden Road
Central
Hong Kong

Dear Mr. Chairman,

Guidelines to Regulate Merger and Acquisition Activity in the Hong Kong Telecommunications Market ("the Guidelines")

We refer to the draft Guidelines that the Office of Telecommunications Authority issued for second consultation on 23 December. We understand that the TA wishes to publish the guidelines very much in the same form as the draft used for second consultation to bring into force the Telecommunications (Amendment) Ordinance 2003 ("the Amendment Ordinance").

As we and other operators have shared with you, the Guidelines which the TA is now finalizing for publication has not settled many valid concerns raised by the industry during the 2 rounds of consultation. The guidelines are still in need of significant improvement to give certainty and predictability of the TA assessment process. In some instances where the TA claims to be following international best practice, we note that there are in fact deviations. We have tried very hard in discussion with the TA with a view to effect the needed amendments to the Guidelines but have not been able to resolve issues with the TA.

A most notable objection we have to the Guidelines is how the TA proposes to take into account an operator's strategic behaviour in considering whether or not there is any barrier to entry to a market, as part of the competition analysis of a market. In sections 4.53 – 4.58 of the Guidelines, there is a strident pronouncement by the TA that the advantages created by a first mover in the market may well be viewed as making barrier to entry.

We have reviewed the relevant merger guidelines adopted by the regulators in the US, EU, UK and Australia. In relation to an operator's strategic behavior creating barrier to entry, these guidelines only refer to that of an incumbent operator. We do not find there was any such proposition in relation to first-movers in these overseas guidelines. We enclose for your ease of reference the relevant extracts of these guidelines.

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The dire consequence of mixing up a first-mover with an incumbent operator in a given market is that it gives a wrong message to investors, local or foreign, that the Hong Kong regulatory regime may view first-movers negatively and this will dampen operators' incentive to bring abut innovative moves and advancement.

What is also more worrying is that the same discussion of first-mover advantages is repeated verbatim in the "Draft Telecommunications Authority Guidelines on Anti-competitive Conduct in Hong Kong Telecommunications Markets". The TA is now seeking to implement such guidelines for the purpose of interpreting and applying the anti-competition conduct provisions (i.e. Section 7K, 7L & 7N) of the Telecommunications Ordinance. The consequence of adopting the same view in interpreting what constitutes anti-competitive conduct under the Ordinance is that advantages created from being first in the market may well be viewed as anti-competitive and may be held in breach of the Ordinance. It is a very disheartening message to the industry.

It is important to acknowledge that attempting to become the first mover is part of the competition process. It is entirely different from the position of an incumbent operator which is either under no threat of new entry or only at risk of new entry upon liberalisation of the market. The incumbent has the dominant position in a market to make barrier to entry an issue. To the contrary, the position of a first-mover in a non-monopolistic market is immediately contestable as regards its initial market power by other new entrants including those operators who have delayed in launching the service.

The draft guidelines on anti-competitive conduct is now under first consultation. Over 50% of the content of such guidelines are copied word for word from the Merger Guidelines. If the Merger Guidelines are allowed to be concluded now with all its flaws, the industry will either suffer from both sets of guidelines having the same flaws or these guidelines being different with multiple confusing standards. It is legitimate for the industry to expect that the 2 guidelines be considered and settled at the same time, with ample opportunity being given for the industry and the public to be duly consulted.

In light of the above, we would urge the above outstanding issues be properly dealt with before the Guidelines be endorsed to become effective.

Yours sincerely,
For and on behalf of
Hutchison Telecommunications
(Hong Kong) Limited

Oswald Kwok
Senior Legal Counsel

Encl.

cc: Ms. Polly Yeung, Clerk to IT Panel (Fax No. 2121 0420)

if, in response to such an effect, rival sellers likely would replace any localized competition lost through the merger by repositioning their product lines.(23)

In markets where it is costly for buyers to evaluate product quality, buyers who consider purchasing from both merging parties may limit the total number of sellers they consider. If either of the merging firms would be replaced in such buyers, consideration by an equally competitive seller not formerly considered, then the merger is not likely to lead to a unilateral elevation of prices.

2.22 Firms Distinguished Primarily by Their Capacities

Where products are relatively undifferentiated and capacity primarily distinguishes firms and shapes the nature of their competition, the merged firm may find it profitable unilaterally to raise price and suppress output. The merger provides the merged firm a larger base of sales on which to enjoy the resulting price rise and also eliminates a competitor to which customers otherwise would have diverted their sales. Where the merging firms have a combined market share of at least thirty-five percent, merged firms may find it profitable to raise price and reduce joint output below the sum of their premerger outputs because the lost markups on the foregone sales may be outweighed by the resulting price increase on the merged base of sales.

This unilateral effect is unlikely unless a sufficiently large number of the merged firm's customers would not be able to find economical alternative sources of supply, i.e., competitors of the merged firm likely would not respond to the price increase and output reduction by the merged firm with increases in their own outputs sufficient in the aggregate to make the unilateral action of the merged firm unprofitable. Such non-party expansion is unlikely if those firms face binding capacity constraints that could not be economically relaxed within two years or if existing excess capacity is significantly more costly to operate than capacity currently in use.(24)

3. ENTRY ANALYSIS

3.0 Overview

A merger is not likely to create or enhance market power or to facilitate its exercise, if entry into the market is so easy that market participants, after the merger, either collectively or unilaterally could not profitably maintain a price increase above premerger levels. Such entry likely will deter an anticompetitive merger in its incipiency, or deter or counteract the competitive effects of concern.

Entry is that easy if entry would be timely, likely, and sufficient in its magnitude, character and scope to deter or counteract the competitive effects of concern. In markets where entry is that easy (i.e., where entry passes these tests of timeliness, likelihood, and sufficiency), the merger raises no antitrust concern and ordinarily requires no further analysis.

The committed entry treated in this Section is defined as new competition that requires expenditure of significant sunk costs of entry and exit.(25) The Agency employs a three step methodology to assess whether committed entry would deter or counteract a competitive effect of concern.

The first step assesses whether entry can achieve significant market impact within a timely period. If significant market impact would require a longer period, entry will not

deter or counteract the competitive effect of concern.

The second step assesses whether committed entry would be a profitable and, hence, a likely response to a merger having competitive effects of concern. Firms considering entry that requires significant sunk costs must evaluate the profitability of the entry on the basis of long term participation in the market, because the underlying assets will be committed to the market until they are economically depreciated. Entry that is sufficient to counteract the competitive effects of concern will cause prices to fall to their premerger levels or lower. Thus, the profitability of such committed entry-must be determined on the basis of premerger market prices over the long-term.

A merger having anticompetitive effects can attract committed entry, profitable at premerger prices, that would not have occurred premerger at these same prices. But following the merger, the reduction in industry output and increase in prices associated with the competitive effect of concern may allow the same entry to occur without driving market prices below premerger levels. After a merger that results in decreased output and increased prices, the likely sales opportunities available to entrants at premerger prices will be larger than they were premerger, larger by the output reduction caused by the merger. If entry could be profitable at premerger prices without exceeding the likely sales opportunities--opportunities that include pre-existing pertinent factors as well as the merger-induced output reduction--then such entry is likely in response to the merger.

The third step assesses whether timely and likely entry would be sufficient to return market prices to their premerger levels. This end may be accomplished either through multiple entry or individual entry at a sufficient scale. Entry may not be sufficient, even though timely and likely, where the constraints on availability of essential assets, due to incumbent control, make it impossible for entry profitably to achieve the necessary level of sales. Also, the character and scope of entrants' products might not be fully responsive to the localized sales opportunities created by the removal of direct competition among sellers of differentiated products. In assessing whether entry will be timely, likely, and sufficient, the Agency recognizes that precise and detailed information may be difficult or impossible to obtain. In such instances, the Agency will rely on all available evidence bearing on whether entry will satisfy the conditions of timeliness, likelihood, and sufficiency.

3.1 Entry Alternatives

The Agency will examine the timeliness, likelihood, and sufficiency of the means of entry (entry alternatives) a potential entrant might practically employ, without attempting to identify who might be potential entrants. An entry alternative is defined by the actions the firm must take in order to produce and sell in the market. All phases of the entry effort will be considered, including, where relevant, planning, design, and management; permitting, licensing, and other approvals; construction, debugging, and operation of production facilities; and promotion (including necessary introductory discounts), marketing, distribution, and satisfaction of customer testing and qualification requirements.[(26)]

Recent examples of entry, whether successful or unsuccessful, may provide a useful starting point for identifying the necessary actions, time requirements, and characteristics of possible entry alternatives.

3.2 Timeliness of Entry

In order to deter or counteract the competitive effects of concern, entrants quickly must

achieve a significant impact on price in the relevant market. The Agency generally will consider timely only those committed entry alternatives that can be achieved within two years from initial planning to significant market impact.(27) Where the relevant product is a durable good, consumers, in response to a significant commitment to entry, may defer purchases by making additional investments to extend the useful life of previously purchased goods and in this way deter or counteract for a time the competitive effects of concern. In these circumstances, if entry only can occur outside of the two year period, the Agency will consider entry to be timely so long as it would deter or counteract the competitive effects of concern within the two year period and subsequently.

3.3 Likelihood of Entry

An entry alternative is likely if it would be profitable at premerger prices, and if such prices could be secured by the entrant.(28) The committed entrant will be unable to secure prices at premerger levels if its output is too large for the market to absorb without depressing prices further. Thus, entry is unlikely if the minimum viable scale is larger than the likely sales opportunity available to entrants.

Minimum viable scale is the smallest average annual level of sales that the committed entrant must persistently achieve for profitability at premerger prices.(29) Minimum viable scale is a function of expected revenues, based upon premerger prices,(30)

and all categories of costs associated with the entry alternative, including an appropriate rate of return on invested capital given that entry could fail and sunk costs, if any, will be lost.(31)

Sources of sales opportunities available to entrants include:

(a) the output reduction associated with the competitive effect of concern, (32)

(b) entrants' ability to capture a share of reasonably expected growth in market demand,(33)

(c) entrants' ability securely to divert sales from incumbents, for example, through vertical integration or through forward contracting, and (d) any additional anticipated contraction in incumbents' output in response to entry. (34) Factors that reduce the sales opportunities available to entrants include: (a) the prospect that an entrant will share in a reasonably expected decline in market demand, (b) the exclusion of an entrant from a portion of the market over the long term because of vertical integration or forward contracting by incumbents, and (c) any anticipated sales expansion by incumbents in reaction to entry, either generalized or targeted at customers approached by the entrant, that utilizes prior irreversible investments in excess production capacity. Demand growth or decline will be viewed as relevant only if total market demand is projected to experience long-lasting change during at least the two year period following the competitive effect of concern.

3.4 Sufficiency of Entry

Inasmuch as multiple entry generally is possible and individual entrants may flexibly choose their scale, committed entry generally will be sufficient to deter or counteract the

competitive effects of concern whenever entry is likely under the analysis of Section 3.3. However, entry, although likely, will not be sufficient if, as a result of incumbent control, the tangible and intangible assets required for entry are not adequately available for entrants to respond fully to their sales opportunities. In addition, where the competitive effect of concern is not uniform across the relevant market, in order for entry to be sufficient, the character and scope of entrants' products must be responsive to the localized sales opportunities that include the output reduction associated with the competitive effect of concern. For example, where the concern is unilateral price elevation as a result of a merger between producers of differentiated products, entry, in order to be sufficient, must involve a product so close to the products of the merging firms that the merged firm will be unable to internalize enough of the sales loss due to the price rise, rendering the price increase unprofitable.

4. Efficiencies

Competition usually spurs firms to achieve efficiencies internally. Nevertheless, mergers have the potential to generate significant efficiencies by permitting a better utilization of existing assets, enabling the combined firm to achieve lower costs in producing a given quantity and quality than either firm could have achieved without the proposed transaction. Indeed, the primary benefit of mergers to the economy is their potential to generate such efficiencies.

Efficiencies generated through merger can enhance the merged firm's ability and incentive to compete, which may result in lower prices, improved quality, enhanced service, or new products. For example, merger-generated efficiencies may enhance competition by permitting two ineffective (e.g., high cost) competitors to become one effective (e.g., lower cost) competitor. In a coordinated interaction context (see Section 2.1), marginal cost reductions may make coordination less likely or effective by enhancing the incentive of a maverick to lower price or by creating a new maverick firm. In a unilateral effects context (see Section 2.2), marginal cost reductions may reduce the merged firm's incentive to elevate price. Efficiencies also may result in benefits in the form of new or improved products, and efficiencies may result in benefits even when price is not immediately and directly affected. Even when efficiencies generated through merger enhance a firm's ability to compete, however, a merger may have other effects that may lessen competition and ultimately may make the merger anticompetitive.

The Agency will consider only those efficiencies likely to be accomplished with the proposed merger and unlikely to be accomplished in the absence of either the proposed merger or another means having comparable anticompetitive effects. These are termed *merger-specific efficiencies*.[35] Only alternatives that are practical in the business situation faced by the merging firms will be considered in making this determination; the Agency will not insist upon a less restrictive alternative that is merely theoretical.

Efficiencies are difficult to verify and quantify, in part because much of the information relating to efficiencies is uniquely in the possession of the merging firms. Moreover, efficiencies projected reasonably and in good faith by the merging firms may not be realized. Therefore, the merging firms must substantiate efficiency claims so that the Agency can verify by reasonable means the likelihood and magnitude of each asserted efficiency, how and when each would be achieved (and any costs of doing so), how each would enhance the merged firm's ability and incentive to compete, and why each would be merger-specific. Efficiency claims will not be considered if they are vague or speculative or otherwise cannot be verified by reasonable means.

Cognizable efficiencies are merger-specific efficiencies that have been verified and do

35. Although capacity constraints are more likely to be important when goods are relatively homogeneous, they may also be important where firms offer differentiated products.

Merged entity able to hinder expansion by competitors

36. Some proposed mergers would, if allowed to proceed, significantly impede effective competition by leaving the merged firm in a position where it would have the ability and incentive to make the expansion of smaller firms and potential competitors more difficult or otherwise restrict the ability of rival firms to compete. In such a case, competitors may not, either individually or in the aggregate, be in a position to constrain the merged entity to such a degree that it would not increase prices or take other actions detrimental to competition. For instance, the merged entity may have such a degree of control, or influence over, the supply of inputs ([46]) or distribution possibilities ([47]) that expansion or entry by rival firms may be more costly. Similarly, the merged entity's control over patents ([48]) or other types of intellectual property (e.g. brands ([49])) may make expansion or entry by rivals more difficult. In markets where interoperability between different infrastructures or platforms is important ([50]), a merger may give the merged entity the ability and incentive to raise the costs or decrease the quality of service of its rivals ([51]). In making this assessment the Commission may take into account, *inter alia*, the financial strength of the merged entity relative to its rivals ([52]).

Merger eliminates an important competitive force

37. Some firms have more of an influence on the competitive process than their market shares or similar measures would suggest. A merger involving such a firm may change the competitive dynamics in a significant, anti-competitive way, in particular when the market is already concentrated ([53]). For instance, a firm may be a recent entrant that is expected to exert significant competitive pressure in the future on the other firms in the market.

38. In markets where innovation is an important competitive force, a merger may increase the firms' ability and incentive to bring new innovations to the market and, thereby, the competitive pressure on rivals to innovate in that market. Alternatively, effective competition may be significantly impeded by a merger between two important innovators, for instance between two companies with 'pipeline' products related to a specific product market. Similarly, a firm with a relatively small market share may nevertheless be an important competitive force if it has promising pipeline products ([54]).

Coordinated effects

39. In some markets the structure may be such that firms would consider it possible, economically rational, and hence preferable, to adopt on a sustainable basis a course of action on the market aimed at selling at increased prices. A merger in a concentrated market may significantly impede effective competition, through the creation or the strengthening of a collective dominant position, because it increases the likelihood that firms are able to coordinate their behaviour in this way and raise prices, even without entering into an agreement or resorting to a concerted practice within the meaning of Article 81 of the Treaty ([55]). A merger may also make coordination easier, more stable or more effective for firms, that were already coordinating before the merger, either by making the coordination more robust or by permitting firms to coordinate on even higher prices.

40. Coordination may take various forms. In some markets, the most likely coordination may involve keeping prices above the competitive level. In other markets, coordination may aim at limiting production or the amount of new capacity brought to the market. Firms may also coordinate by dividing the market, for instance by geographic area ([56]) or other customer characteristics, or by allocating contracts in bidding markets.

41. Coordination is more likely to emerge in markets where it is relatively simple to reach a common understanding on the terms of coordination. In addition, three conditions are necessary for coordination to be sustainable. First, the coordinating firms must be able to monitor to a sufficient degree whether the terms of coordination are being adhered to. Second, discipline requires that there is some form of credible deterrent mechanism that can be activated if deviation is detected. Third, the reactions of outsiders, such as current and future competitors not participating in the coordination, as well as customers, should not be able to jeopardise the results expected from the coordination ([57]).

42. The Commission examines whether it would be possible to reach terms of coordination and whether the coordination is likely to be sustainable. In this respect, the Commission considers the changes that the merger brings about. The reduction in the number of firms in a market may, in itself, be a factor that facilitates coordination. However, a merger may also increase the likelihood or significance of coordinated effects in other ways. For instance, a merger may involve a 'maverick' firm that has a history of preventing or disrupting coordination, for example by failing to follow price increases by its competitors, or has characteristics that gives it an incentive to favour different strategic choices than its coordinating competitors would prefer. If the merged firm were to adopt strategies similar to those of other competitors, the remaining firms would find it easier to coordinate, and the merger would increase the likelihood, stability or effectiveness of coordination.

43. In assessing the likelihood of coordinated effects, the Commission takes into account all available relevant information on the characteristics of the markets concerned, including both structural features and the past behaviour of firms ([58]). Evidence of past coordination is important if the relevant market characteristics have not changed appreciably or are not likely to do so in the near future ([59]). Likewise, evidence of coordination in similar markets may be useful information.

63. In order to assess whether a merger would significantly impede effective competition by creating or strengthening buyer power, an analysis of the competitive conditions in upstream markets and an evaluation of the possible positive and negative effects described above are therefore required.

V. COUNTERVAILING BUYER POWER

64. The competitive pressure on a supplier is not only exercised by competitors but can also come from its customers. Even firms with very high market shares may not be in a position, post-merger, to significantly impede effective competition, in particular by acting to an appreciable extent independently of their customers, if the latter possess countervailing buyer power (79). Countervailing buyer power in this context should be understood as the bargaining strength that the buyer has vis-à-vis the seller in commercial negotiations due to its size, its commercial significance to the seller and its ability to switch to alternative suppliers.

65. The Commission considers, when relevant, to what extent customers will be in a position to counter the increase in market power that a merger would otherwise be likely to create. One source of countervailing buyer power would be if a customer could credibly threaten to resort, within a reasonable timeframe, to alternative sources of supply should the supplier decide to increase prices (80) or to otherwise deteriorate quality or the conditions of delivery. This would be the case if the buyer could immediately switch to other suppliers (81), credibly threaten to vertically integrate into the upstream market or to sponsor upstream expansion or entry (82) for instance by persuading a potential entrant to enter by committing to placing large orders with this company. It is more likely that large and sophisticated customers will possess this kind of countervailing buyer power than smaller firms in a fragmented industry (83). A buyer may also exercise countervailing buying power by refusing to buy other products produced by the supplier or, particularly in the case of durable goods, delaying purchases.

66. In some cases, it may be important to pay particular attention to the incentives of buyers to utilise their buyer power (84). For example, a downstream firm may not wish to make an investment in sponsoring new entry if the benefits of such entry in terms of lower input costs could also be reaped by its competitors.

67. Countervailing buyer power cannot be found to sufficiently off-set potential adverse effects of a merger if it only ensures that a particular segment of customers (85), with particular bargaining strength, is shielded from significantly higher prices or deteriorated conditions after the merger (86). Furthermore, it is not sufficient that buyer power exists prior to the merger, it must also exist and remain effective following the merger. This is because a merger of two suppliers may reduce buyer power if it thereby removes a credible alternative.

VI. ENTRY

68. When entering a market is sufficiently easy, a merger is unlikely to pose any significant anti-competitive risk. Therefore, entry analysis constitutes an important element of the overall competitive assessment. For entry to be considered a sufficient competitive constraint on the merging parties, it must be shown to be likely, timely and sufficient to deter or defeat any potential anti-competitive effects of the merger.

Likelihood of entry

69. The Commission examines whether entry is likely or whether potential entry is likely to constrain the behaviour of incumbents post-merger. For entry to be likely, it must be sufficiently profitable taking into account the price effects of injecting additional output into the market and the potential responses of the incumbents. Entry is thus less likely if it would only be economically viable on a large scale, thereby resulting in significantly depressed price levels. And entry is likely to be more difficult if the incumbents are able to protect their market shares by offering long-term contracts or giving targeted pre-emptive price reductions to those customers that the entrant is trying to acquire. Furthermore, high risk and costs of failed entry may make entry less likely. The costs of failed entry will be higher, the higher is the level of sunk cost associated with entry (87).

70. Potential entrants may encounter barriers to entry which determine entry risks and costs and thus have an impact on the profitability of entry. Barriers to entry are specific features of the market, which give incumbent firms advantages over potential competitors. When entry barriers are low, the merging parties are more likely to be constrained by entry. Conversely, when entry barriers are high, price increases by the merging firms would not be significantly constrained by entry. Historical examples of entry and exit in the industry may provide useful information about the size of entry barriers.

71. Barriers to entry can take various forms:

(a) Legal advantages encompass situations where regulatory barriers limit the number of market participants by, for example, restricting the number of licences (88). They also cover tariff and non-tariff trade barriers (89).

(b) The incumbents may also enjoy technical advantages, such as preferential access to essential facilities, natural resources (90), innovation and R & D (91), or intellectual property rights (92), which make it difficult for any firm to compete successfully. For instance, in certain industries, it might be difficult to obtain essential input materials, or patents might protect products or processes. Other factors such as economies of scale and scope, distribution and sales networks (93), access to important technologies, may also constitute barriers to entry.

(c) Furthermore, barriers to entry may also exist because of the established position of the incumbent firms on the market. In particular, it may be difficult to enter a particular industry because experience or reputation is necessary to compete effectively, both of which may be difficult to obtain as an entrant. Factors such as consumer loyalty to a particular brand [94], the closeness of relationships between suppliers and customers, the importance of promotion or advertising, or other advantages relating to reputation [95] will be taken into account in this context. Barriers to entry also encompass situations where the incumbents have already committed to building large excess capacity [96], or where the costs faced by customers in switching to a new supplier may inhibit entry.

72. The expected evolution of the market should be taken into account when assessing whether or not entry would be profitable. Entry is more likely to be profitable in a market that is expected to experience high growth in the future [97] than in a market that is mature or expected to decline [98]. Scale economies or network effects may make entry unprofitable unless the entrant can obtain a sufficiently large market share [99].

73. Entry is particularly likely if suppliers in other markets already possess production facilities that could be used to enter the market in question, thus reducing the sunk costs of entry. The smaller the difference in profitability between entry and non-entry prior to the merger, the more likely such a reallocation of production facilities.

Timeliness

74. The Commission examines whether entry would be sufficiently swift and sustained to deter or defeat the exercise of market power. What constitutes an appropriate time period depends on the characteristics and dynamics of the market, as well as on the specific capabilities of potential entrants [100]. However, entry is normally only considered timely if it occurs within two years.

Sufficiency

75. Entry must be of sufficient scope and magnitude to deter or defeat the anti-competitive effects of the merger [101]. Small-scale entry, for instance into some market 'niche', may not be considered sufficient.

VII. EFFICIENCIES

76. Corporate reorganisations in the form of mergers may be in line with the requirements of dynamic competition and are capable of increasing the competitiveness of industry, thereby improving the conditions of growth and raising the standard of living in the Community [102]. It is possible that efficiencies brought about by a merger counteract the effects on competition and in particular the potential harm to consumers that it might otherwise have [103]. In order to assess whether a merger would significantly impede effective competition, in particular through the creation or the strengthening of a dominant position, within the meaning of Article 2(2) and (3) of the Merger Regulation, the Commission performs an overall competitive appraisal of the merger. In making this appraisal, the Commission takes into account the factors mentioned in Article 2(1), including the development of technical and economic progress provided that it is to the consumers' advantage and does not form an obstacle to competition [104].

77. The Commission considers any substantiated efficiency claim in the overall assessment of the merger. It may decide that, as a consequence of the efficiencies that the merger brings about, there are no grounds for declaring the merger incompatible with the common market pursuant to Article 2(3) of the Merger Regulation. This will be the case when the Commission is in a position to conclude on the basis of sufficient evidence that the efficiencies generated by the merger are likely to enhance the ability and incentive of the merged entity to act pro-competitively for the benefit of consumers, thereby counteracting the adverse effects on competition which the merger might otherwise have.

78. For the Commission to take account of efficiency claims in its assessment of the merger and be in a position to reach the conclusion that as a consequence of efficiencies, there are no grounds for declaring the merger to be incompatible with the common market, the efficiencies have to benefit consumers, be merger-specific and be verifiable. These conditions are cumulative.

Benefit to consumers

79. The relevant benchmark in assessing efficiency claims is that consumers [105] will not be worse off as a result of the merger. For that purpose, efficiencies should be substantial and timely, and should, in principle, benefit consumers in those relevant markets where it is otherwise likely that competition concerns would occur.

80. Mergers may bring about various types of efficiency gains that can lead to lower prices or other benefits to consumers. For example, cost savings in production or distribution may give the merged entity the ability and incentive to charge lower prices following the merger. In line with the need to ascertain whether efficiencies will lead to a net benefit to consumers, cost efficiencies that lead to reductions in variable or marginal costs [106] are more likely to be relevant to the assessment of efficiencies than reductions in fixed costs; the former are, in principle, more likely to result in lower prices for consumers [107]. Cost reductions, which merely result from anti-competitive reductions in output, cannot be considered as efficiencies benefiting consumers.

81. Consumers may also benefit from new or improved products or services, for instance resulting from efficiency gains in the sphere of R & D and innovation. A joint venture company set up in order to develop a new product may bring about the type of efficiencies that the Commission can take into account.

(26) See paragraph 17.

(27) Also often called 'unilateral' effects.

(28) Such expected reactions by competitors may be a relevant factor influencing the merged entity's incentives to increase prices.

(29) An oligopolistic market refers to a market structure with a limited number of sizeable firms. Because the behaviour of one firm has an appreciable impact on the overall market conditions, and thus indirectly on the situation of each of the other firms, oligopolistic firms are interdependent.

(30) Recital 25 of the Merger Regulation.

(31) See, in particular, paragraphs 17 and 18.

(32) Products may be differentiated in various ways. There may, for example, be differentiation in terms of geographic location, based on branch or stores location; location matters for retail distribution, banks, travel agencies, or petrol stations. Likewise, differentiation may be based on brand image, technical specifications, quality or level of service. The level of advertising in a market may be an indicator of the firms' effort to differentiate their products. For other products, buyers may have to incur switching costs to use a competitor's product.

(33) For the definition of the relevant market, see the Commission's Notice on the definition of the relevant market for the purposes of Community competition law, cited above.

(34) See for example Case COMP/M.2817 — Barilla/BPS/Kamps, point 34; Commission Decision 2001/403/EC in Case COMP/M.1672 — Volvo/Scania, OJ L 143, 29.5.2001, p. 74, points 107-148.

(35) See, e.g. Commission Decision 94/893/EC in Case IV/M.430 — Procter & Gamble/VP Schickedanz (II), OJ L 354, 21.6.1994, p. 32, Case T-290/94, Kaysersberg v Commission, [1997] II-2137, paragraph 153; Commission Decision 97/610/EC in Case IV/M.774 — Saint-Gobain/Wacker-Chemie/NOM, OJ L 247, 10.9.1997, p. 1, point 179; Commission Decision 2002/156/EC in Case COMP/M.2097 — SCA/Metsä Tissue, OJ L 57, 27.2.2002, p. 1, points 94-108; Case T-310/01, Schneider v Commission, [2002] II-4071, paragraph 418.

(36) Typically, the relevant margin (m) is the difference between price (p) and the incremental cost (c) of supplying one more unit of output expressed as a percentage of price (m = (p - c)p)).

(37) See, e.g. Case IV/M.1980 — Volvo/Renault VI, point 34; Case COMP/M.2256 — Philips Agilent/Health Care Solutions, points 33-35; Case COMP/M.2537 — Philips/Marconi Medical Systems, points 31-34.

(38) The cross-price elasticity of demand measures the extent to which the quantity of a product demanded changes in response to a change in the price of some other product, all other things remaining equal. The own-price elasticity measures the extent to which demand for a product changes in response to the change in the price of the product itself.

(39) The diversion ratio from product A to product B measures the proportion of the sales of product A lost due to a price increase of A that are captured by product B.

(40) Commission Decision 97/816/EC in Case IV/M.877 — Boeing/McDonnell Douglas, OJ L 336, 8.12.1997, p. 16, points 58 et seq.; Case COMP/M.3083 — GE/Instrumentarium, points 125 et seq.

(41) Sunk costs are costs which are unrecoverable upon exit from the market.

(42) See e.g. Commission Decision 2002/156/EC in Case IV/M.877 — Boeing/McDonnell Douglas, OJ L 336, 8.12.1997, p. 16, point 70.

(43) See, e.g. Case IV/M. 986 — Agfa Gevaert/DuPont, OJ L 211, 29.7.1998, p. 22, points 63-71.

(44) See, e.g. Case COMP/M.2187 — CVC/Lenzing, points 162-170.

(45) When analysing the possible expansion of capacity by rivals, the Commission considers factors similar to those described in Section VI on entry. See, e.g. Case COMP/M.2187 — CVC/Lenzing, points 162-173.

(46) See, e.g. Case T-221/95, Endemol v Commission, [1999] ECR II-1299, paragraph 167.

(47) See, e.g. Case T-22/97, Kesko v Commission, [1999], ECR II-3775, paragraphs 141 et seq.

(48) See, e.g. Commission Decision 2001/684/EC in Case M.1671 — Dow Chemical/Union Carbide OJ L 245, 14.9.2001, p. 1, points 107-114.

(49) See, e.g. Commission Decision 96/435/EC in Case IV/M.623 — Kimberly-Clark/Scott, OJ L 183, 23.7.1996, p. 1; Case T-114/02, Babyliss SA v Commission ('Seb/Moulinex'), [2003] ECR II-000, paragraphs 343 et seq.

(50) This is, for example, the case in network industries such as energy, telecommunications and other communication industries.

(51) Commission Decision 99/287/EC in Case IV/M.1069 — Worldcom/MCI, OJ L 116, 4.5.1999, p. 1, points 117 et seq.; Case IV/M.1741 — MCI Worldcom/Sprint, points 145 et seq.; Case IV/M.1795 — Vodafone Airtouch/Mannesmann, points 44 et seq.

(52) Case T-156/98 RJB Mining v Commission [2001] ECR II-337.

(53) Commission Decision 2002/156/EC in Case IV/M.877 — Boeing/McDonnell Douglas, OJ L 336, 8.12.1997, p. 16, point 58; Case COMP/M.2568 — Haniel/Ytong, point 126.

(54) For an example of pipeline products of one merging party likely to compete with the other party's pipeline or existing products, see, e.g. Case IV/M.1846 — Glaxo Wellcome/SmithKline Beecham, point 188.

(55) Case T-102/96, Gencor v Commission, [1999] ECR II-753, paragraph 277; Case T-342/99, Airtours v Commission, [2002] ECR II-2585, paragraph 61.

(56) This may be the case if the oligopolists have tended to concentrate their sales in different areas for historic reasons.

([57]) Case T-342/99, Airtours v Commission, [2002] ECR II-2585, paragraph 62.

([58]) See Commission Decision 92/553/EC in Case IV/M.190 — Nestlé/Perrier, OJ L 356, 5.12.1992, p. 1, points 117-118.

([59]) See, e.g. Case IV/M.580 — ABB/Daimler-Benz, point 95.

([60]) See, e.g. Commission Decision 2002/156/EC in Case COMP/M.2097 — SCA/Metsä Tissue, OJ L 57, 27.2.2002, p. 1, point 148.

([61]) See, e.g. Case IV/M.1298 — Kodak/Imation, point 60.

([62]) Case T-102/96, Gencor v Commission, [1999] ECR II-753, paragraph 222; Commission Decision 92/553/EC in Case IV/M.190 — Nestlé/Perrier, OJ L 356, 5.12.1992, p. 1, points 63-123.

([63]) In assessing whether or not a merger may increase the symmetry of the various firms present on the market, efficiency gains may provide important indications (see also paragraph 82 of the notice).

([64]) See, e.g. Commission Decision 2001/519/EC in Case COMP/M.1673 — VEBA/VIAG, OJ L 188, 10.7.2001, p. 1, point 226; Case COMP/M.2567 — Nordbanken/Postgirot, point 54.

([65]) See, e.g. Case COMP/M.2389 — Shell/DEA, points 112 et seq.; and Case COMP/M.2533 — BP/E.ON, points 102 et seq.

([66]) See also Commission Decision 2000/42/EC in Case IV/M.1313 — Danish Crown/Vestjyske Slagterier, OJ L 20, 25.1.2000, p. 1, points 176-179.

([67]) See, e.g. Case COMP/M.2640 — Nestlé/Schöller, point 37; Commission Decision 1999/641/EC in Case COMP/M.1225 — Enso/Stora, OJ L 254, 29.9.1999, p. 9, points 67-68.

([68]) See, e.g. Case IV/M.1939 — Rexam (PLM)/American National Can, point 24.

([69]) See Case COMP/M.2389 — Shell/DEA, point 121, and Case COMP/M.2533 — BP/E.ON, point 111.

([70]) Although deterrent mechanisms are sometimes called 'punishment' mechanisms, this should not be understood in the strict sense that such a mechanism necessarily punishes individually a firm that has deviated. The expectation that coordination may break down for a certain period of time, if a deviation is identified as such, may in itself constitute a sufficient deterrent mechanism.

([71]) See, e.g. Commission Decision 2000/42/EC in Case IV/M.1313 — Danish Crown/Vestjyske Slagterier, OJ L 20, 25.1.2000, p. 1, point 177.

([72]) See Case T-102/96, Gencor v Commission, [1999] ECR II-753, paragraph 281.

([73]) These elements are analysed in a similar way to non-coordinated effects.

([74]) See, e.g. Case IV/M.1630 — Air Liquide/BOC, points 201 et seq. For an example of a case where entry by the other merging firm was not sufficiently likely in the short to medium term (Case T-158/00, ARD v Commission, [2003] ECR II-000, paragraphs 115-127).

([75]) Commission Decision 2001/98/EC in Case IV/M.1439 — Telia/Telenor, OJ L 40, 9.2.2001, p. 1, points 330-331, and Case IV/M.1681 — Akzo Nobel/Hoechst Roussel Vet, point 64.

([76]) Case IV/M.1630 — Air Liquide/BOC, point 219; Commission Decision 2002/164/EC in Case COMP/M.1853 — EDF/EnBW, OJ L 59, 28.2.2002, p. 1, points 54-64.

([77]) See Commission Decision 1999/674/EC in Case M.1221 — Rewe/Meinl, OJ L 274, 23.10.1999, p. 1, points 71-74.

([78]) Case T-22/97, Kesko v Commission, [1999] ECR II-3775, paragraph 157; Commission Decision 2002/156/EC in Case M.877 — Boeing/McDonnell Douglas, OJ L 336, 8.12.1997, p. 16, points 105-108.

([79]) See, e.g. Case IV/M.1882 — Pirelli/BICC, points 73-80.

([80]) See, e.g. Case IV/M.1245 — Valeo/ITT Industries, point 26.

([81]) Even a small number of customers may not have sufficient buyer power if they are to a large extent 'locked in' because of high switching costs (see Case COMP/M.2187 — CVC/Lenzing, point 223).

([82]) Commission Decision 1999/641/EC in Case COMP/M.1225 — Enso/Stora, OJ L 254, 29.9.1999, p. 9, points 89-91.

([83]) It may also be appropriate to compare the concentration existing on the customer side with the concentration on the supply side (Case COMP/JV 55 — Hutchison/RCPM/ECT, point 119, and Commission Decision 1999/641/EC in Case COMP/M.1225 — Enso/Stora, OJ L 254, 29.9.1999, p. 9, point 97).

([84]) Case COMP/JV 55 — Hutchison/RCPM/ECT, points 129-130.

([85]) Commission Decision 2002/156/EC in Case COMP/M.2097 — SCA/Metsä Tissue, OJ L 57, 27.2.2002, point 88. Price discrimination between different categories of customers may be relevant in some cases in the context of market definition (See the Commission's notice on the definition of the relevant market, cited above, at paragraph 43).

([86]) Accordingly, the Commission may assess whether the various purchasers will hold countervailing buyer power, see, e.g. Commission Decision 1999/641/EC in Case COMP/M.1225 — Enso/Stora, OJ L 254, 29.9.1999, p. 9, points 84-97.

([87]) Commission Decision 97/610/EC in Case IV/M.774 — Saint-Gobain/Wacker-Chemie/NOM, OJ L 247, 10.9.1997, p. 1, point 184.

([88]) Case IV/M.1430 — Vodafone/Airtouch, point 27; Case IV/M.2016 — France Télécom/Orange, point 33.

([89]) Commission Decision 2002/174/EC in Case COMP/M.1693 — Alcoa/Reynolds, OJ L 58, 28.2.2002, point 87.

([90]) Commission Decision 95/335/EC in Case IV/M.754 — Anglo American Corp./Lonrho, OJ L 149, 20.5.1998, p. 21, points 118-119.

([91]) Commission Decision 97/610/EC in Case IV/M.774 — Saint-Gobain/Wacker-Chemie/NOM, OJ L 247, 10.9.1997, p. 1, points 184-187.

([92]) Commission Decision 94/811/EC in Case IV/M.269 — Shell/Montecatini, OJ L 332, 22.12.1994, p. 48, point 32.

(93) Commission Decision 98/327/EC in Case IV/M.833 — The Coca-Cola Company/Carlsberg A/S, OJ L 145, 15.5.1998, p. 41, point 74.

(94) Commission Decision 98/327/EC in Case IV/M.833 — The Coca-Cola Company/Carlsberg A/S, OJ L 145, 15.5.1998, p. 41, points 72-73.

(95) Commission Decision 2002/156/EC in Case COMP/M.2097 — SCA/Metsä Tissue, OJ L 57, 27.2.2002, p. 1, points 83-84.

(96) Commission Decision 2001/432/EC in Case IV/M.1813 — Industri Kapital Nordkem/Dyno, OJ L 154, 9.6.2001, p. 41, point 100.

(97) See, e.g. Commission Decision 98/475/EC in Case IV/M.986 — Agfa-Gevaert/Dupont, OJ L 211, 29.7.1998, p. 22, points 84-85.

(98) Case T-102/96, Gencor v Commission, [1999] ECR II-753, paragraph 237.

(99) See, e.g. Commission Decision 2000/718/EC in Case IV/M.1578 — Sanitec/Sphinx, OJ L 294, 22.11.2000, p. 1, point 114.

(100) See, e.g. Commission Decision 2002/174/EC in Case COMP/M.1693 — Alcoa/Reynolds, L 58, 28.2.2002, points 31-32, 38.

(101) Commission Decision 91/535/EEC in Case IV/M.68 — Tetra Pak/Alfa Laval, OJ L 290, 22.10.1991, p. 35, point 3.4.

(102) See Recital 4 of the Merger Regulation.

(103) See Recital 29 of the Merger Regulation.

(104) Cf. Article 2(1)(b) of the Merger Regulation.

(105) Pursuant to Article 2(1)(b), the concept of 'consumers' encompasses intermediate and ultimate consumers, i.e. users of the products covered by the merger. In other words, consumers within the meaning of this provision include the customers, potential and/or actual, of the parties to the merger.

(106) Variable costs should be viewed as those costs that vary with the level of production or sales over the relevant time period. Marginal costs are those costs associated with expanding production or sales at the margin.

(107) Generally, fixed cost savings are not given such weight as the relationship between fixed costs and consumer prices is normally less direct, at least in the short run.

(108) In line with the general principle set out in paragraph 9 of this notice.

(109) Joined Cases C-68/94 and C-30/95, Kali and Salz, paragraph 110.

(110) Joined Cases C-68/94 and C-30/95, Kali and Salz, paragraph 114. See also Commission Decision 2002/365/EC in Case COMP/M.2314 — BASF/Pantochim/Eurodiol, OJ L 132, 17.5.2002, p. 45, points 157-160. This requirement is linked to the general principle set out in paragraph 9 of this notice.

(111) The inevitability of the assets of the failing firm leaving the market in question may, in particular in a case of merger to monopoly, underlie a finding that the market share of the failing firm would in any event accrue to the other merging party. See Joined Cases C-68/94 and C-30/95, Kali and Salz, paragraphs 115-116.

coordinated behaviour, rather than that there is a particular punishment mechanism.

4.16 **Sustainability of coordinated behaviour.** Overall, the conditions of competition in the market should be conducive to tacit coordination in order to sustain the relevant behaviour. Typically, this means that the market should be sufficiently mature, stable and with such limited competition (both actual and potential) that the coordination is not likely to be disrupted. For example, a strong fringe of smaller competitors (or perhaps a single maverick firm) or a strong buyer (with buyer power) might be enough to destabilise the oligopoly and render tacit coordination impossible.

Entry and expansion

4.17 Entry by new competitors or expansion by existing competitors may be sufficient in time, scope, and likelihood to deter or defeat any attempt by the merging parties or their competitors to exploit the reduction in rivalry flowing from the merger (whether through coordinated or non-coordinated strategies).

New entry

4.18 New entry and the threat of entry can represent important competitive constraints on the behaviour of merging firms. If entry is particularly easy and likely, then the mere threat of entry may be sufficient to deter the merging parties from raising their prices since any price increase or reduction in output/quality would incentivise that new entry to take place.

4.19 Before new entry (or the threat thereof) may be considered a sufficient competitive constraint, three conditions must be satisfied.

4.20 First, the OFT will examine whether new entry may be expected to occur in the event that the merging parties seek to exercise market power. In this regard, the OFT may review:

- barriers to entry to the market (or markets) and the costs of entry to determine if new entry is in fact feasible,

- the experience of any firms that have entered or withdrawn from the relevant market or markets in recent years,
- evidence of planned entry by third parties, and
- the minimum viable scale needed for entry.

4.21 Entry barriers may be broadly defined as any feature of a market that gives incumbent firms an advantage over potential entrants, such that incumbents can persistently raise their prices above (or reduce quality below) competitive levels without new firms entering the market. In assessing the extent of such barriers, the OFT will consider absolute and strategic incumbency advantages, and the costs of entry.

- Absolute advantages include situations where government regulations, such as licensing, intellectual property rights, or preferential access to essential facilities limit the number of competitors that are able to enter a market.
- Strategic advantages arise where incumbent firms have advantages over new entrants because of their established position (first-mover advantages) or if incumbent firms are expected to behave strategically, for example, by responding to entry with very low prices or by investing in excess capacity or additional brands to deter entry.
- The costs of entering a market are more likely to deter entry where a significant proportion of those cost are sunk, i.e. the costs cannot be recovered if the entrant fails and is forced to exit. Sunk costs are the costs of entering a market that are not recoverable when exiting, and may include set-up costs (such as market research, finding a location and getting planning permission) but may also include costs associated with investment in specific assets, research and advertising or other promotion costs.
- Economies of scale arise where average costs fall as the level of output rises.[25] In some circumstances, such scale economies can act as a barrier to entry, particularly where the fixed costs are sunk. As a result, a new entrant may be deterred from attempting to match the costs of the incumbent by entering on a large scale, because of the risks that they would be unable to recover their sunk costs.

[25] Economies of scope, where average costs fall the more types of products are supplied, may have similar implications to economies of scale.

- The costs of entry must be considered against the expected revenues from sales and the time period over which costs might be recovered, to assess whether firms wanting to enter the market will find entry profitable and whether or not it may be difficult for them to raise such funds. In assessing whether entry would be profitable, the OFT will generally do so by reference to pre-merger prices since this is the price at which the merged entity would need to be constrained to avoid an indication of a substantial lessening of competition.
- The costs faced by customers in switching to a new supplier are also important in determining whether new entry would be an effective and timely competitive constraint.

4.22 Second, any new entry should be of sufficient scope to constrain any attempt to exploit greater post merger market power. Small-scale entry, perhaps into some market niche, may be insufficient to prevent a substantial lessening of competition, even when the entry may be the basis for later expansion.

4.23 Third, the OFT would also need to be satisfied that any such prospective new entry in response to any exercise of market power by the merged firm would be sufficiently timely and sustainable to provide lasting and effective post merger competition. Entry within less than two years will generally be timely, but this must be assessed on a case by case basis.

4.24 Analysis of entry conditions includes considering whether the merged entity would face competition from imports or supply-side substitution to the extent that these have not already been taken into account in market definition. What is important is that competitive constraints posed by imports and possible supply-side substitutes are counted in the analysis (whether they are counted under the heading of market definition or that of entry).

4.25 The effect of a merger on the possibility and/or likelihood of new entry might itself contribute to a substantial lessening of competition where a merger increases barriers to entry or otherwise reduces/eliminates the competitive constraint represented by new

entry. This might arise, for example, where the acquired entity was one of the most likely entrants or was genuinely perceived as such by those already in the market: in other words, the merger would substantially lessen pressure from potential competitors. In addition, in some markets, a merger might lead to 'tipping', where the parties' products (or services) would become adopted as the industry standard and competitive pressure may be significantly reduced as a result.

Expansion

4.26 The ability of rival firms in the market to expand their capacity quickly can also act as an important competitive constraint on the merging parties' behaviour. When considering the probability of such expansion as a response to price increases, the OFT will consider similar factors to those set out above for new market entry.

Countervailing buyer power

4.27 The ability of a merged entity to raise prices may be constrained by the countervailing power of buyers. There is a variety of different ways in which a powerful customer might be able to discipline supplier pricing.

- Most commonly, a buyer can simply switch, or credibly threaten to switch, its demand or a part thereof to another supplier. Whether buyers will maintain the same ability to choose among suppliers after the merger is a key issue.
- Even where a customer has (or customers have) no choice but to take the supplier's products, they may still be able to constrain prices if they are able to impose substantial costs on the supplier, e.g. by refusing to buy other products produced by the supplier or by delaying purchases, that they can use as leverage to defeat proposed price increases.
- Retailers may also be able to impose costs on the supplier through their own retail practices, e.g. by positioning the supplier's products in less favourable parts of the shop.

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- changes to tariff levels and other forms of protection which are likely to occur over the next two or three years;
- information that overseas corporations have concrete plans to enter the Australian market;
- data on the impact of exchange rate changes on the viability and market share of imports;
- information about the availability and potential availability and influence of imports in different parts of Australia; and
- practical difficulties in importing versus local supply in relation to the nature of the product and its demand, e.g. perishability (both physical and fashion related), the importance of rapid supply response and the costs of holding inventories.

5.113 In some markets import competition may impose a constraint on the merged firm via a downstream market. This is a parallel issue to part of the question of functional market definition discussed in paragraphs 5.67–5.70. If the merged firms' customers are closely constrained in their ability to pass on input price increases by effective import competition, the merged firm may not be able to significantly increase its prices. Similar information will be relevant here to that listed in paragraph 5.70 in relation to functional market definition.

5.114 Where a merger raises competition concerns on the demand side of a market, exports can play a similar role in constraining the market power of buyers to the role played by imports in constraining the market power of suppliers. That is, if the merged firm buys from producers in an export industry it will not be able to depress domestic prices below competitive levels because this would result in supply switching to export markets. Hence the merger would be unlikely to substantially lessen competition.

Barriers to entry

5.115 Merger factor (b) requires the Commission to consider the height of barriers to entry to the market. Even where a merger breaches the concentration thresholds and import competition is not effective, if the market is characterised by low barriers to new entry incumbent firms are likely to be constrained by the threat of potential competition to behave in a manner consistent with competitive market outcomes. However, if there are significant barriers to the entry of new suppliers, an increase in concentration to levels above the Commission's thresholds, in the absence of significant import competition, is likely to give rise to a substantial lessening of competition.

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5.116 Barriers to entry can be any feature of a market that places an efficient prospective entrant at a significant disadvantage compared with incumbent firms. They may consist of sunk costs; legal or regulatory barriers; access to scarce resources enjoyed by incumbent firms; economies of scale and scope; product differentiation and brand loyalty; and the threat of retaliatory action by incumbents.

5.117 Sunk costs are costs which are unrecoverable on exit, creating a risk from entry. Their extent depends on factors such as capital specificity, whether there are developed markets in rental of equipment and requirements for investment in advertising and promotion.

5.118 Legal and regulatory barriers such as licensing requirements, planning or environmental controls or industry standards, may directly limit the number of competitors in a market, or may add to the sunk costs of entry through specific capital requirements.

5.119 Scarce resources may consist of physical resources such as mineral deposits or intellectual resources such as patents.

5.120 Economies of scale and scope, both plant and multi-plant, may inhibit entry depending on expected post-entry prices, which in turn will depend on factors such as the minimum efficient scale of entry, cost penalties associated with sub-optimal plant utilisation, price elasticity of demand and market growth.

5.121 Product differentiation and brand loyalty may affect both the level and elasticity of demand faced by a new entrant compared to an incumbent firm and add to the sunk cost requirements of entry in the form of advertising and promotion costs.

5.122 The threat of retaliatory action by incumbents may also create a barrier to new entry. Potential entrants may anticipate predatory behaviour by incumbent firms on the basis of past behaviour in this or other markets. Such threats may pose an effective deterrent, even in markets which may otherwise appear to have relatively low barriers to entry.

5.123 The 'height' of barriers to entry indicates the extent to which incumbents can raise the market price above its competitive level without attracting entry. It is not necessary for a merger to increase barriers to entry for it to be anti-competitive; only that significant barriers exist, providing incumbents with discretion in pricing and other conduct. If the merger also increases barriers to entry, the anti-competitive effects are likely to be more severe.

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5.124 In considering the height of barriers to entry, the Commission will have regard to the following types of information:

- sunk costs in both production capacity, accessing shelf space, advertising and promotion;
- any regulatory restrictions on entry, such as licensing requirements and industry standards;
- any requirements for scarce inputs;
- the extent of brand loyalty enjoyed by incumbents;
- minimum efficient scale of operation;
- cost penalties for operating at sub-optimal capacity;
- price elasticity of demand;
- market growth or decline; and
- potential response of incumbents to new entry.

5.125 Dr Brunt has provided the following useful test of what constitutes a significant barrier to entry for trade practices purposes:

> The essential test for whether or not there is a significant barrier to entry can be expressed simply enough: it is whether the threat of entry of whatever kind will constrain incumbents to behave competitively. It follows that neither initial entry nor eventual established supply must necessarily be of the full-line variety. Leading firms can be constrained by a collection of more specialised rivals. Firms may enter at one scale or one product-range and grow to another. However we cannot speak of easy entry if the only viable entry is that which occurs at the fringe of the market in competition with that fraction of the incumbents' business that has high marginal costs; or if the only viable entry is of the fringe products that fail to attack the incumbents' core business. There must be, in Richard Schmalensee's phrase, 'real pressure on established firms' profits'.[69]

5.126 The Commission considers that effective entry is that which is likely to have a market impact within a two year period, either by deterring or defeating the attempted exercise of significant market power by the merged firm. In some markets the threat of entry is sufficient to constrain firm conduct. In others, actual entry will be required. The latter would require entry on a sufficient scale and which offered a product sufficiently attractive to consumers to be effective.

5.127 When the market impact of actual or potential entry on the merged firm's conduct occurs is likely to vary with the nature of the goods or services supplied. For example, where purchases are one-off, such as building services, actual entry may be required before there is any impact on current conduct, since high prices today are unlikely to deter tomorrow's customers. However, for goods which are subject to repeat purchases and significant consumer loyalty, potential entry is more likely to have an impact on current conduct, which has the potential to lose customers in the future. Product life can also be important. Consumers may

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choose to extend the life of their existing durable goods rather than buy new ones if the price is too high. In such markets, entry need not occur as swiftly to be effective. In markets characterised by bidding for large scale contracts, a potential entrant may be able to exert pressure on incumbent firms' conduct by submitting bids in advance of physical entry. If successful, those contracts could then provide the springboard for entry, e.g. an international firm considering entry into the Australian market or a firm operating in one State considering the extension of its operations inter-state.

5.128 The Commission will have particular regard to evidence of the past success or failure of new entrants in establishing themselves as mainstream competitors in the relevant market. Historical evidence of high prices and profits being maintained for long periods without encouraging new corporations to enter the market, or historical evidence of firms entering, failing and leaving the market, will suggest there are barriers to successful effective entry to the relevant market. Also relevant will be evidence of concrete plans by major corporations, either domestic or overseas, to launch a major entry into the market. However, if the historical record is one of failed entry, the Commission will need to be convinced that these plans are likely to meet with more success than those of past entrants.

Countervailing power

5.129 Merger factor (d) requires the Commission to consider the degree of countervailing power in the market. Countervailing power exists where a supplier (buyer) faces a buyer (supplier) with market power or a credible threat of vertical integration (or other form of bypass) or direct importing. In such cases, the ability of the merged firm to increase (decrease) prices may be constrained and the likelihood of a substantial lessening of competition diminished.

5.130 The Commission does not consider that countervailing power is synonymous with small numbers of buyers (suppliers). As discussed in paragraph 5.87, market concentration is a necessary but not sufficient condition for market power. Furthermore, as discussed in paragraph 5.20, the ability of buyers to depress prices below competitive levels tends to be inhibited by elastic supply conditions in many markets. However, as noted in paragraph 5.168, large infrequent purchases, such as long term contracts with major customers, may tend to undermine attempts at coordinated conduct.

5.131 If pre-merger prices are distorted from competitive levels by market power on the opposite side of the market, a merger may actually move prices closer to competitive levels and increase market efficiency. For example, a merger of buyers in a market may create countervailing power which can push prices down closer to competitive levels. If those firms face broader competition in their