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Keep 'em un-coordinated*

COORDINATED EFFECTS IN MERGERS

The Australian Competition and Consumer Commission (ACCC) has been placing increased emphasis on the possibility of 'coordinated effects' as a reason for deciding to oppose mergers between firms. While concerns about mergers resulting in potentially harmful coordinated effects have a solid grounding in economic theory, quantifying them robustly can be difficult. For this reason, assessing coordinated effects will often rely on qualitative assessments. To be credible these assessments need to establish a realistic explanation of the degree of likelihood and damage to competition of the coordinated conduct following a merger.

Coordinated effects involve an increase in market power as a result of joint or accommodating actions of firms following a merger. They imply some anticipation, be it tacit or explicit, of complementary reactions by rival firms that give rise to increased profits for the merged and other firms. These effects can be contrasted to unilateral effects, under which the increase in market power from a merger arises from a firm acting alone without implicit or explicit collusion or cooperation with other firms.

Traditional competition analysis of mergers is directed at determining market definition, market shares and changes in price, quality and output. These analyses

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are relevant to assessing the potential for both unilateral effects and coordinated effects. However, in assessing coordinated effects, further assumptions and investigations need to be made about firm inter-dependence.

THE THEORY OF COORDINATED EFFECTS

The theoretical underpinnings of coordinated effects are traceable to the economics of tacit collusion (where collusion is based on each firm having expectations about the reactions of others to its behaviour, rather than formally discussed and agreed activities). A well-known paper by George Stigler suggests that tacit collusion is more likely to occur when:

- firms have the incentive and ability to suppress competition;
- cheating on the collusive arrangement can be easily and quickly detected;
- punishment or threat of punishment for cheating is possible and effective; and
- the collusive outcome is not subject to destabilisation by outside forces.[†]

These factors determine what the firm could get out of entering into, or breaking from, a collusive agreement with other firms. In deciding to break from a collusive arrangement, a firm will compare the extra profits it can make from cheating now, with the discounted value of profits given up in future when rivals react.

Under this framework, collusion (and coordinated effects) is more likely when there is:

- a smaller number of firms and greater concentration in the market;
- symmetric market shares of the firms in the market;
- a high level of price and quantity transparency; and
- regular exchange of information and communication between firms through, for example, public posting of prices or participation in meetings or other activities of a trade association.

Coordinated effects are less likely when:

- there are low barriers to entry of new firms;
- buyers have countervailing power; and
- an industry 'maverick' is willing and able to operate outside, and undermine, the conduct.[‡]

ISSUES OF QUANTIFICATION

Quantification of the effects of a merger can be crucial to guide decision making. However, the traditional oligopoly simulation models of price and quantity competition often used in merger analysis only capture unilateral effects. This is because one of the underlying assumptions of these models is that each firm

independently maximises its own profits, rather than the profits of a group of firms or industry as a whole.

In the United States, researchers have recently attempted to estimate the incentives of firms to engage in coordinated conduct by fitting data to a model of differentiated products price competition. This involved quantifying the increase in profits the firms could achieve from collusion, as well as determining the sustainability of collusion, by calculating the payoffs from unilateral deviations from the collusive outcome.[§]

However, we think there are three major shortcomings with this technique that mean it is likely to overstate the gains from coordinating post-merger. First, it assumes coordination takes the form of a further merger (i.e. perfect collusion) between the merging and selected non-merging firms, which seems unlikely. Second, the model can imply that major coordinated effects result from relatively small gains in market share of a firm simply as a result of unrelated assumptions made about post-merger coordination. Third, the assumption that there is no coordinated conduct pre-merger could mean that more gains from coordination are attributed to the merger than would be the case in practice.

Because of the problems in applying simulation methods, econometric estimation will often be a better way of indicating the extent to which a merger is likely to create problems because of co-ordinated effects. Econometric analysis can capture both unilateral and coordinated effects by estimating the effects on prices of previous mergers as well as the effects on prices of differences in market concentration across regions. Conventionally applied, this analysis will not isolate the separate contribution of coordinated effects. However, this objective might be achieved, at least in part, by isolating input parameters that are associated with coordinated effects, but not unilateral effects. As an example, using a measure of a firm's level of communication with other firms, such as the number of pricing announcements or trade association meetings attended, it might be possible to isolate coordinated effects.

The difficulty of quantifying coordinated effects is one reason why the analysis of these effects often tends to be more qualitative in nature. This involves making professional judgements, with reference to the theoretical literature and case studies, about conditions that make coordination more or less likely. To be credible, these assessments need to be able to establish a realistic explanation of the degree of likelihood and damage to competition of the coordinated conduct following a merger. This requires being able to assess the relevance of the theory and other evidence to the particular economic conditions of the merger under consideration.

SOME RECENT ACCC DECISIONS

The ACCC's 2008 Merger Guidelines outline concerns about potential coordinated effects from mergers, and increase the emphasis placed on these effects compared with the previous Guidelines issued in 1999. Further, concerns about coordinated effects have been more prominent in ACCC decisions to block acquisitions in the past 12 months.

Two recent decisions were Caltex's proposed acquisition of Mobil service stations, and Link Market Service's (Link's) proposed acquisition of the registry services company Newreg (Registries).

In the Caltex case, the ACCC relied on the greater potential for coordinated effects to reject the merger outright. It took the view that the proposed acquisition would increase the risk of more stable and effective coordinated pricing behaviour in *metropolitan* markets in the 'restoration phase' of the observed weekly retail petrol price cycles. The reasoning was that under counterfactual scenarios where the service station sales sites were to be bought by alternative retailers to Caltex, these retailers were more likely to lag price restorations. This, according to the ACCC, would lead to greater price uncertainty and less possibility of retail price coordination.

In the case of the proposed Link merger with Registries, the ACCC rejected the merger on the basis of concerns about the potential for both coordinated effects and unilateral effects. In relation to the former, it was concerned that the acquisition of Registries by Link would remove a 'maverick' firm from the market, which would make the possibility of coordinated conduct between the remaining two registry providers more likely. The ACCC was particularly concerned about increased likelihood of tacit market sharing with only two registry providers, leading to higher prices.

In both cases, the ACCC relied entirely on a qualitative assessment of coordinated effects to reach its conclusions.

CONCLUSIONS

Consideration of coordinated effects is gaining importance in merger assessments in Australia. While the economic theory of coordinated effects is quite well developed, the use of robust quantitative techniques for determining the magnitude of these effects can be problematic. Given this, judgements about the importance of coordinated effects will often tend to be more qualitative in nature. These will require careful arguments being made by proponents of mergers and the ACCC using robust theory and other evidence applicable to the conditions of the merger.

Frontier (Australia) has advised a number of firms on coordinated effects in merger cases considered by the ACCC.

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* With apologies to The Offspring and its song *Keep 'em Separated.*

† Summarised by Ordover, J. A., 2008, 'Coordinated Effects' in *Issues in Competition Law and Policy* (Chapter 57).

‡ This is a non-exhaustive list taken from Motta, M., 2004, *Competition Policy – Theory and Practice.*

§ Kovacic, W. E., et. al., 2009, 'Quantitative Analysis of Coordinated Effects' in *Antitrust Law Journal,* Vol. 76, No. 2.

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