TOO CLOSE FOR COMFORT: THE ROLE OF CLOSENESS OF COMPETITION IN PHILIPPINE MERGER ANALYSIS*

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ABSTRACT

The development of Philippine competition law is still in its early stages. In the realm of horizontal merger assessment, practitioners and authorities alike may be bound by domestic statute, rules, and guidelines, yet they inevitably turn to the practice of more developed jurisdictions for guidance. Consistent with the approach adopted by such jurisdictions, such as the United States and the United Kingdom, this Article demonstrates that closeness of competition between the merging parties plays a central role in assessing the likely unilateral effects of a horizontal merger involving differentiated goods. However, closeness of competition fails to consider dynamic responses of rivals and customers and is inadequate to determine coordinated effects. Thus, competition authorities must examine all competitive restraints in order to arrive at a comprehensive assessment.

I. INTRODUCTION

The passage of the Philippine Competition Act (Republic Act No. 10667, "PCA") marked the introduction of an antitrust regime in the Philippines. Prior to its enactment in 2015, competition issues went largely unnoticed and unaddressed by domestic statute. The Revised Penal Code (on monopolies and combinations in restraint of trade) and the Corporation Code (on mergers and acquisitions) provided little guidance in this regard. Since the passage of the PCA and the establishment of the Philippine Competition Commission ("PCC" or "Commission"), the body of Philippine competition law and policy has grown by leaps and bounds. In its first three years, the

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Commission has introduced a number of issuances—rules, guidelines, and clarificatory notes—in an effort to guide businesses and the public alike. Yet, despite all these developments, there remains room for improvement, as the practice area itself is constantly evolving and adapting to the changing times.

The PCA saw the establishment of a compulsory notification regime for qualified mergers and acquisitions.[1] The law set out in general terms the legal test to be applied in determining whether or not a merger should be prohibited: the PCC must assess whether or not the merger would substantially prevent, restrict, or lessen competition in the relevant market for goods or services.[2] However, the law stops short of defining *how* the likelihood of the harm that might arise would be assessed. The PCC has thus needed to fill in the gaps and craft accompanying guidelines. These include the PCA's Implementing Rules and Regulations, the Rules on Merger Procedure, and the Merger Review Guidelines, all of which shall be discussed in this Article. Since Philippine competition law is still in its infancy, these issuances draw heavily from the principles and practices of foreign jurisdictions. One such practice applied by the European Commission ("EC") in the assessment of horizontal mergers is measuring "closeness of competition."[3] This Article argues that analyzing closeness of competition between merging parties is useful in detecting likely unilateral effects, especially in markets involving differentiated goods. On the other hand, closeness may not be relevant where the merging parties' goods are homogenous, or where the theories of harm involve coordinated effects. Moreover, one must also consider, alongside closeness of competition, the exercise of supply- and demand-side responses.

This Article will proceed in four parts: Part I provides an overview of horizontal merger assessment under the PCA, relevant PCC issuances, and international guidance. Part II defines closeness of competition and explores its role in determining unilateral effects. Other competitive constraints influencing unilateral effects analysis are described in Part III. Part IV briefly discusses coordinated effects as a component of horizontal merger assessment.

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[1] Rep. Act No. 10667 (2015) [hereinafter "PCA"], § 17. Philippine Competition Act.

[2] PCA, § 20.

[3] "Closeness of competition" refers to the degree to which two products are substitutable with one another.

II. HORIZONTAL MERGER ASSESSMENT: AN OVERVIEW

A. Mergers Under Philippine Law

Prior to the passage of the PCA, legal treatment of mergers was prescribed by the Corporation Code of the Philippines (Batas Pambansa Blg. 68, "Corporation Code"). A *merger* under the Corporation Code is characterized by the joining of two corporations "into a single corporation[,] which shall be one of the constituent corporations."[4] This is distinguished from a *consolidation*, which involves the formation of an entirely new entity.[5] The definition of a merger under the Corporation Code was carried over to the Revised Corporation Code,[6] which was signed into law on February 20, 2019. Under the Revised Corporation Code, mergers and consolidations must be approved by the Securities and Exchange Commission ("SEC") before they take effect.[7] The law provides additional requirements in the case of banks or banking institutions, loan associations, trust companies, insurance companies, public utilities, educational institutions, and other special corporations governed by special laws, such that mergers and consolidations of such entities require the favorable recommendation of the appropriate government agency as a prerequisite to SEC approval.[8]

On the other hand, the PCA's definition of a merger is a two-pronged one, embracing the scope of what would be considered a merger or consolidation under the Revised Corporation Code, thus: "*Merger* refers to the joining of two (2) or more entities into an existing entity **or** to form a new entity."[9]

Under the Rules and Regulations to Implement the Provisions of Republic Act No. 10667 ("PCA IRR"), this definition was expanded to include the creation of joint ventures.[10]

The PCC in its Merger Review Guidelines further classifies mergers into two broad categories: horizontal and non-horizontal mergers. A *horizontal merger* is a merger of entities whose products or services directly compete with one another in the same market, while non-horizontal mergers can be further

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[4] CORP. CODE, § 76. Batas Blg. 68 (1980).
[5] CORP. CODE, § 76.
[6] REV. CORP. CODE. Rep. Act No. 11232 (2019).
[7] REV. CORP. CODE, § 78.
[8] REV. CORP. CODE, § 78.
[9] PCA, § 4(j). (Emphasis supplied.)
[10] Rules and Regulations to Implement the Provisions of Republic Act No. 10667 [hereinafter "PCA IRR"] (2016), Rule 2(k).

classified as vertical or conglomerate mergers.[11] *Vertical mergers* involve entities operating at different levels of the production or supply chain, such as those between customers and suppliers.[12] On the other hand, *conglomerate mergers* involve entities that are related neither horizontally nor vertically.[13] **Figure 1** below illustrates the different types of mergers:

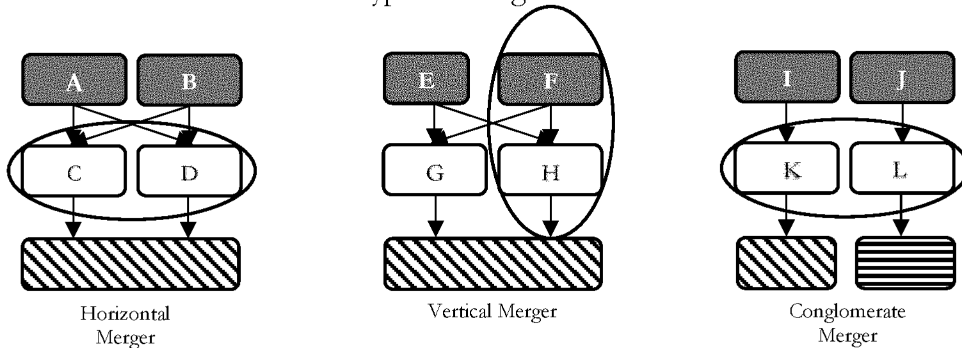

Figure 1. Horizontal, Vertical, and Conglomerate Mergers.[14]

Pre-PCA, the Philippine merger control regime simply consisted of the SEC's approval and of the merging parties' Articles of Merger.[15] This regime changed drastically with the establishment of the PCC and the introduction of the compulsory notification regime prescribed by the PCA which will be discussed later in this Article.

Given the mandatory nature of the merger notification and the far-reaching implications for noncompliance, the PCC has set out, in a series of issuances, the requirements for notification, the procedure to be followed, and the standards utilized by the Commission in the assessment of mergers.

B. Thresholds for Merger Notification

At present, notification to the PCC is compulsory for mergers and acquisitions[16] breaching the specified size-of-party and size-of-transaction

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[11] PCC Merger Review Guidelines (2016), § 4.7(a) and (b).

[12] PCC Merger Review Guidelines (2016), § 4.7 (b)(i).

[13] PCC Merger Review Guidelines (2016), § 4.7 (b)(ii).

[14] SIMON BISHOP & MIKE WALKER, THE ECONOMICS OF EC COMPETITION LAW 349 (2010).

[15] CORP. CODE, § 79; REV. CORP. CODE, § 78.

[16] *See* PCA, § 4 (a).

"Section 4. *Definition of Terms*. – As used in this Act:

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thresholds. However, when the PCA was first passed in 2015, the law provided only for a size-of-transaction threshold amounting to PHP 1,000,000,000.00,[17] leaving to the PCC the authority to revise such threshold.[18] The PCA IRR formally instituted the size-of-party and size-of-transaction thresholds, which were set at PHP 1,000,000,000.00 each.[19]

Under the PCA IRR, the size-of-party threshold is satisfied where:

> "[t]he aggregate annual gross revenues in, into or from the Philippines, or value of the assets in the Philippines of the ultimate parent entity of at least one of the acquiring or acquired entities, including that of all entities that the ultimate parent entity controls, directly or indirectly, exceeds One Billion Pesos (PhP1,000,000,000.00)."

On the other hand, the size-of-transaction threshold refers to the value of the transaction, which must likewise exceed PHP 1,000,000,000.00, measured by assets and/or revenues depending on the nature of the transaction, thus:[20]

Type of transaction	What must exceed PHP 1 billion
Proposed merger or acquisition of *assets in the Philippines*	Aggregate value of assets in the Philippines being acquired in the proposed transaction *or* Gross revenues generated in the Philippines by assets acquired in the Philippines

(a) *Acquisition* refers to the purchase of securities or assets, through contract or other means, for the purpose of obtaining control by:

(1) One (1) entity of the whole or part of another;
(2) Two (2) or more entities over another; or
(3) One (1) or more entities over one (1) or more entities;"

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[17] PCA, § 17.
[18] PCA, §§ 12(b), 17.
[19] PCA IRR, Rule 4, § 3.
[20] PCA IRR, Rule 4, § 3(b) and (d).

Proposed merger or acquisition of *assets outside the Philippines*	Aggregate value of assets in the Philippines of the acquiring entity *and* Gross revenues generated in or into the Philippines by those assets acquired outside the Philippines
Proposed merger or acquisition of *assets inside and outside the Philippines*	Aggregate value of assets in the Philippines of the acquiring entity *and* Aggregate gross revenues generated in or into the Philippines by assets acquired in the Philippines and any assets acquired outside the Philippines
Proposed acquisition of: • **voting shares of a corporation; or of** • **an interest in a non-corporate entity**	1a. Aggregate value of assets in the Philippines that are owned by the corporation or non-corporate entity or by entities it controls, other than assets that are shares of any of those corporations *or* 1b. Gross revenues from sales in, into, or form the Philippines of the corporation or non-corporate entity or by entities in controls, other than assets that are shares of any of those corporations *moreover,* 2a. As a result of the proposed acquisition of the voting shares of a corporation, the entity or entities acquiring the shares, together with their affiliates, would own voting shares of the corporation that, in the aggregate, carry more than the following percentages of the votes attached to all the corporation's outstanding voting shares: • 35%; or • 50%, if the entity or entities already own more than 35% before the proposed acquisition; *or*

	2b. As a result of the proposed acquisition of an interest in a non-corporate entity, the entity or entities acquiring the interest, together with their affiliates, would hold an aggregate interest in the non-corporate entity that entitles the entity or entities to receive more than the following percentages of the profits of the noncorporate entity or assets of that non-corporate entity on its dissolution: • 35%; or • 50%, if the entity or entities acquiring the interest are already entitled to receive more than 35% before the proposed acquisition.
Notifiable joint venture transaction	Aggregate value of the assets that will be combined in the Philippines or contributed into the joint venture *or* Gross revenues generated in the Philippines by assets to be combined in the Philippines or contributed into the proposed joint venture

Table 1. Size-of-Transaction Thresholds under the PCA IRR.

Consistent with its mandate under the PCA, on March 1, 2018, the PCC issued Memorandum Circular No. 18-001 ("MC 18-001"), increasing the size-of-party threshold to PHP 5,000,000,000.00[21] and the size-of-transaction threshold to PHP 2,000,000,000.00[22]. MC 18-001 likewise provides that the thresholds will be automatically adjusted annually using the Philippines' gross domestic product growth as an index.[23] Most recently, on February 11, 2020, Commission Resolution No. 02-2020 was passed increasing the size-of-party and size-of-transaction thresholds to PHP 6,000,000,000.00 and PHP 2,400,000,000.00, respectively.

Assuming that both the size-of-party and size-of-transaction thresholds are breached, the merging parties must file their Notification

[21] PCC Memorandum Circular No. 18-001 (2018), § 1. Amendment of Rule 4, Section 3 of the Implementing Rules and Regulations of Republic Act No. 10667.

[22] PCC Memorandum Circular No. 18-001 (2018), § 1.

[23] PCC Memorandum Circular No. 18-001 (2018), § 3.

Forms before the PCC within 30 days after the signing of definitive agreements relating to the merger.[24]

C. Standards for Merger Assessment

Section 20 of the PCA prescribes the standard for reviewing a notified merger or acquisition. If the PCC determines that such transaction will substantially prevent, restrict, or lessen competition in the relevant market for goods or services,[25] then the transaction will be prohibited. This standard is similar, in both style and substance, to the tests employed by competition authorities in the United Kingdom ("UK") and the United States ("US"), both of which utilize the "substantial lessening of competition" ("SLC") test.[26] On the other hand, Canada and South Africa refer to a "substantial prevention or lessening of competition," while the European Union ("EU") looks at whether or not the merger gives rise to a "significant impediment to effective competition" ("SIEC").[27] Despite these differences in terminology, it is submitted that the substantive test is similar across jurisdictions.[28]

Turning back to the Philippines, the recent introduction of the PCA and its framework for merger review meant that there was still no precedent, whether judicial or administrative, to provide clarity on the statute's application. Specifically, there was a need to provide more concrete guidelines on the parameters and application of the SLC test. Thus, the PCC introduced the Merger Review Guidelines, which drew heavily from the International Competition Network's ("ICN") Recommended Practices for Merger Analysis. Under the Merger Review Guidelines, a merger gives rise to an SLC where "it has a significant effect on competition, and consequently, on the competitive pressure on firms to reduce prices, improve quality, [or] become more efficient or innovative."[29]

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[24] 2017 Rules of Merger Procedure of the Philippine Competition Commission, Rule 3.1. N.B. This Article does not purport to describe the entire process of merger notification before the PCC. The reader is advised to consult the PCC website and/or representatives of the Mergers and Acquisitions Office for guidance.

[25] The legal test is abbreviated as "SLC" consistent with the Merger Review Guidelines. The author recognizes that SLC is likewise the acronym used to abbreviate "substantial lessening of competition," which is the test employed by the UK and US, but nonetheless maintains that the two tests, while similar, are distinct.

[26] RICHARD WHISH & DAVID BAILEY, COMPETITION LAW 885 (9d ed. 2018).

[27] GUNNAR NIELS ET AL., ECONOMICS FOR COMPETITION LAWYERS 298 (2d ed. 2016).

[28] *Id.*

[29] PCC Merger Review Guidelines, § 4.2.

In evaluating a notified transaction, the PCC looks into the effects of competition over time in the relevant market or markets affected by the merger.[30] In particular, the PCC examines whether or not the proposed transaction is "likely to harm competition significantly by creating or enhancing market power, either unilaterally or in coordination with rivals."[31] Horizontal mergers are of particular concern to competition authorities worldwide—aside from creating market power for the merged firm, such transactions may eliminate competition between the merging parties or dampen competition between the remaining suppliers in the market.[32]

To aid in the assessment of horizontal mergers, the EC has adopted the *Guidelines on the assessment of horizontal mergers* (the "EC Guidelines"). The EC Guidelines lay emphasis on the following: market shares and concentration thresholds; the likelihood that a merger would have anti-competitive effects; countervailing buyer power; the possibility of entry into the market as a competitive constraint; efficiencies; and failing firms.

The PCC's own Merger Review Guidelines follow a similar structure. Thus, in reviewing a merger, the Mergers and Acquisitions Office ("MAO") will consider the following: market shares and concentration; competitive effects analysis; entry and expansion; efficiencies; and failing firm/exiting assets.

Bulk of this work will focus on the analysis of the effects of a horizontal merger on competition. To determine such effects, the PCC and other competition authorities employ *theories of harm*, which provide the framework for assessing the effects of the merger and the likelihood of the transaction leading to SLC.[33]

Theories of harm in horizontal mergers involve either *unilateral* (also referred to as *non-coordinated*) or *coordinated effects*. Unilateral effects arise when the merged entity has the ability to profitably raise prices regardless of its competitors' responses.[34] In contrast, when coordinated effects arise, the merged entity is able to increase its prices because its rivals choose to compete less vigorously post-merger.[35] The distinction between the two is less clear in

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[30] PCC Merger Review Guidelines, § 4.2.
[31] PCC Merger Review Guidelines, § 7.1.
[32] NIELS ET AL., *supra* note 27.
[33] PCC Merger Review Guidelines, § 4.10.
[34] NIELS ET AL., *supra* note 27, at 301.
[35] BISHOP & WALKER, *supra* note 14, at 390.

practice, as a profitable price rise by a merged entity may not be purely unilateral—suppliers do not usually ignore their competitors' responses.[36]

III. CLOSENESS OF COMPETITION IN UNILATERAL EFFECTS ANALYSIS

A. Unilateral Effects from Horizontal Mergers

A unilateral effects theory of harm suggests that the merged firm can engage in activity detrimental to consumers, not necessarily limited to an increase in price. The merged firm may instead choose to reduce promotions, restrict output and contract capacity, or reduce quality.[37] The intuition is that, without the merger, any attempted price increase by one of the merging firms would likely be unsuccessful because consumers would simply switch to another supplier, including the other merging party. The price rise would be unprofitable if the lost margins on consumers switching or leaving the market are greater than the margins earned on consumers who do not switch.[38] This is illustrated by **Figure 2** below, where the lost margins of Firm 1 due to customer switching post-price increase to its competitors, is greater than the margins earned from remaining customers:

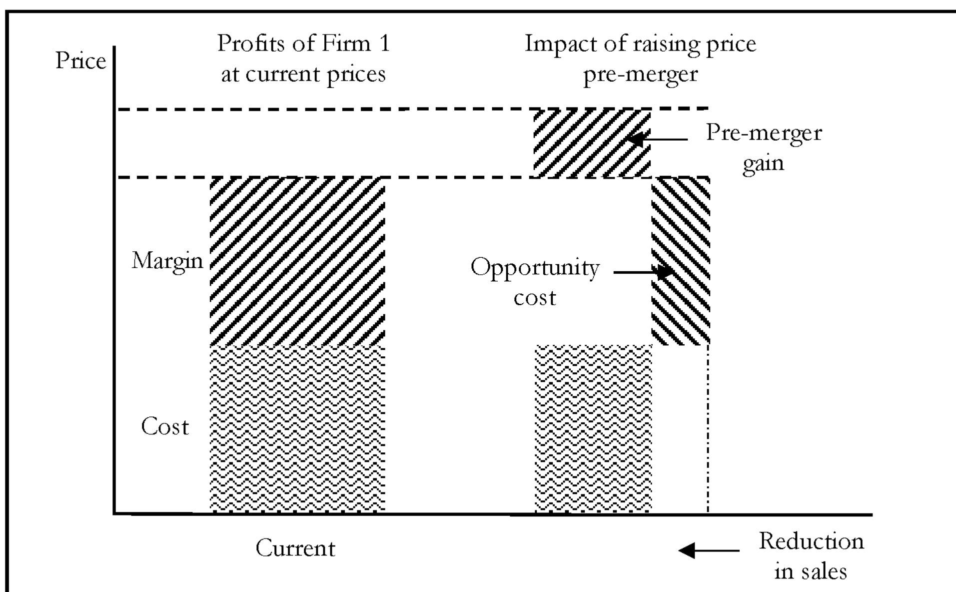

Figure 2. Unprofitable Price Rise by Firm 1 Absent Merger.[39]

[36] NIELS ET AL., *supra* note 27, at 301.

[37] Gregory J. Werden & Luke M. Froeb, *Choosing among Tools for Assessing Unilateral Merger Effects*, 7 EUR. COMPETITION J. 155, 156 (2011).

[38] ADRIAN MAJUMDAR, UNIT 9: UNILATERAL EFFECTS (2019).

[39] BISHOP & WALKER, *supra* note 14, at 368.

Instead, consider a scenario where Firm 1 merges with one of its competitors, Firm 2. Such transaction would allow the merged entity to "recapture" customers that would otherwise have been lost had either firm individually raised its prices.[40] This is shown by **Figure 3** below, where the additional margin from Firm 1's customers that did not switch to Firm 2 post-merger, together with the gain from the customers that did switch, is greater than the opportunity cost:

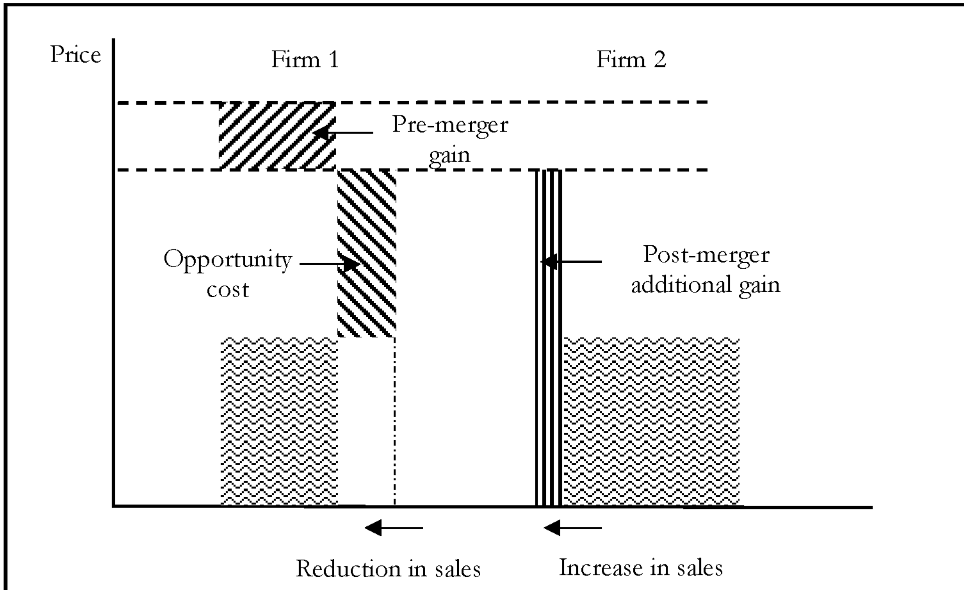

Figure 3. Profitable Price Rise Post-Merger of Firm 1 and 2.[41]

Comparing **Figures 2** and **3**, it is clear that a unilateral price rise implemented by Firm 1 absent a merger would not be profitable, while an increase in Firm 1's price following a merger with Firm 2 would be so. Thus, it is said that such a merger between Firms 1 and 2 would give rise to unilateral effects.

Indeed, unilateral effects analysis lies at the heart of any horizontal merger assessment. In determining whether a merger would allow a merged firm to "recapture" lost sales, the extent to which customers would switch to the other merging party must be measured. This is intuitive: if customers, observing an increase in price from one of the merging firms, switch to a third-party supplier (*i.e.* neither of the merging firms), then there is no ability

[40] Werden & Froeb, *supra* note 37, at 157.
[41] BISHOP & WALKER, *supra* note 14, at 368.

to recapture such customers. On the other hand, if customers switch to the other merging firm (*i.e.* the firm that simply retained its price), then the additional profits from the switching customers are "internalized" by the merged entity. Thus, in unilateral effects analysis, competition authorities consider the "closeness of competition" between the merging parties. It is said that the closer the merging parties are to each other, "the more intense the competition between them, and hence the higher the likelihood of a significant price increase after the merger."[42] The concept of closeness of competition between merging parties shall be discussed further in the section that follows.

B. What is "Closeness of Competition"?

The analysis of closeness of competition is said to be one of the core elements of any merger analysis.[43] The phrase "closeness of competition" is taken to denote the trend of one merging party's customers switching to products supplied by the other party,[44] or the degree to which the products of the merging firms are substitutable. An alternative definition for closeness of competition considers the merging firms' competitive strategies of targeting the same customers or following similar innovation paths.[45] Closeness would then be measured by examining internal strategy or board documents to determine which rivals a company monitors or reacts to the most.[46] This Article will utilize the first, and arguably more common definition.

To recall, a merger gives rise to unilateral effects where the merged firm has the ability to "profitably raise prices, reduce choice or innovation through its own acts, without the need for a coordinated response from competitors."[47] In turn, the tendency for prices to rise post-merger depends on the degree of heterogeneity between the parties' products and their competitors'. If parties are close competitors (*i.e.* there is a great degree of substitutability between them), then there is a greater switching between them, and stronger/more likely unilateral effects.[48] Closeness of competition between two firms has a critical effect on the profitability of a post-merger

[42] NIELS ET AL., *supra* note 27, at 310.

[43] Stephen Thomas, *Close Competitors in Merger Review*, 4 J. EUR. COMPETITION L. & PRACTICE 391, 401 (2013).

[44] IOANNIS KOKKORIS & HOWARD SHELANSKI, EU MERGER CONTROL: A LEGAL AND ECONOMIC ANALYSIS 224 (2014).

[45] JONATHAN PARKER & ADRIAN MAJUMDAR, UK MERGER CONTROL 471 (2d ed. 2016).

[46] NIELS ET AL., *supra* note 27, at 310.

[47] KOKKORIS & SHELANSKI, *supra* note 44, at 224.

[48] *Id.* at 225.

price rise because the more closely substitutable two products are (relative to their substitutability with other products), the greater will be the degree to which substitution away from each of the merging firms' products due to the price increase will be "internalized" into the merged firm.[49] It is thus clear that closeness of competition between the merging parties plays a crucial role in analyzing unilateral effects in horizontal mergers. However, as will be explained below, closeness becomes more relevant in mergers between parties producing *differentiated goods* (*i.e.* those which consumers may view to be substitutable but not identical),[50] as opposed to those producing *homogenous goods* (*i.e.* those that are nearly identical from the purchaser's point of view).[51]

The distinction is vital as the type of goods produced by the merging parties determines whether or not the concept of closeness of competition would be useful in assessing unilateral effects. Consider, for example, the theories and models set forth in the PCC Merger Review Guidelines—in mergers of competitors of differentiated products, the theory of harm is that the merger raises the potential for significant anti-competitive effects if the merging parties are close substitutes.[52] On the other hand, closeness between the merging parties does not seem to play a role in the theories of harm applied to mergers between competitors in undifferentiated product markets[53] or of rivals in bidding or auction markets.[54] This is consistent with the approach adopted by the European Commission and the Competition Markets Authority of the UK; the role of closeness in each type of product market shall be explored in further detail elsewhere in this Article.

C. Measuring Closeness: The Diversion Ratio

In horizontal merger assessment, just as in other areas of competition law, the application of legal principles is deeply intertwined with economic analysis. In particular, economics plays an essential role in determining closeness of competition between the merging parties. The key measure of closeness, as utilized in horizontal merger assessment, is the diversion ratio.[55] Niels, et al. summarize the basic economic logic behind the diversion ratio as follows:[56]

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[49] Roscoe B. Starek III and Stephen Stockhum, *What Makes Mergers Anticompetitive: Unilateral Effects Analysis Under the 1992 Merger Guidelines*, 63 ANTITRUST L.J. 801, 806 (1995).

[50] PARKER & MAJUMDAR, *supra* note 45, at 461.

[51] *Id.* at 510.

[52] PCC Merger Review Guidelines, § 7.7(b).

[53] PCC Merger Review Guidelines, § 7.7(c).

[54] PCC Merger Review Guidelines, § 7.7(d).

[55] NIELS ET AL., *supra* note 27, at 319.

[56] *Id.* at 312.

> [T]he price of a product is raised, some consumers will switch away from that product and spend their money elsewhere. The alternative product that captures most of this diverted expenditure will have the highest diversion ratio, and can be regarded as the closest substitute of the first product. In general, the higher the diversion ratio between two products, the greater the competition is between them, and the more concerned you should be if they merge.

In mergers, therefore, the diversion ratio seeks to measure the "recapture rate," that is, "the extent to which the merger allows the parties to recapture customers that would otherwise have been lost had either firm individually raised its prices."[57] Stated differently, the diversion ratio analyzes "the volumes (or value) lost from one product, the price of which has been raised, that are captured by another product."[58] This analysis goes beyond just measuring each firm's market share.[59] An illustration of the diversion ratio, assuming that firm A (with competitors B, C, and D) increases its prices, is depicted in **Table 2**:

Firm	Sales at current prices	Sales if A raises prices by 5%	Diversion ratio from A
A	100	80	-
B	100	115	75%
C	100	103	15%
D	100	102	10%

Table 2. Illustration of Diversion Ratios.

Based on Table 2 above, 5% increase in A's price would result in a 20% decline in A's sales. The lost sales (20 units) are diverted to its competitors B (5 units), C (3 units), and D (2 units). If market shares are used to indicate diversion, then it would appear that B, C, and D all appear to be providing an equally strong competitive constraint on A because all four firms have equal market shares pre-A's price increase.[60] However, post-price increase, the diverted units were not "distributed" equally among the three

[57] KOKKORIS & SHELANSKI, *supra* note 44, at 225.

[58] PARKER & MAJUMDAR, *supra* note 45, at 471.

[59] The traditional approach to measuring closeness suggests that market shares are reflective of second choices, and therefore, are good indicators of diversion between parties. However, this wholly fails to consider differentiation between products which would influence consumers' perception of which two products are actually "close competitors."

[60] BISHOP & WALKER, *supra* note 14, at 373.

firms. Instead, B has captured most of A's lost sales, thus, the diversion ratio between A and B is greater (75%) than A and C (15%) and A and D (10%). This permits the statement that B is the "closest" substitute to A.[61] In general, the higher the diversion ratio between two products, the greater the competition between them.[62] Hence, in this instance, an AB merger may likely give greater cause for concern than an AC or AD merger. Nonetheless, as will be explained in the succeeding section, the fact that neither merging party is each other's closest competitor does not necessarily mean that a merger between them would not harm competition in the market.

D. Closeness in Differentiated Goods Markets

To recall, differentiated goods are those which consumers view to be substitutable but not identical. The amount of market power that a firm has because of its differentiated products depends predominantly on the degree to which its products are considered by customers to be preferable to the products of its competitors.[63] There are a number of factors which could potentially affect substitutability, including price, quality, image, and other characteristics which might be relevant to the consumer. Consequently, while a number of products may comprise the same relevant market, some of them may be closer and the others, more distant substitutes.[64] Closeness of competition therefore plays a crucial role in assessing the likelihood of a post-merger price rise.

Thus, in differentiated products markets, it is said that unilateral effects are more likely to arise where the merging parties are closest competitors and where there are few remaining competitors, post-merger (and buyer power or likely supply-side responses such as new entry are absent).[65] Referring to the hypothetical firms described in Table 2 above, a price increase by A following its merger with B would lead customers to switch to B, thereby allowing it to "internalize" its lost sales.[66] Accordingly, an AB merger may be more harmful than an AC or AD merger. It is thus said that one of the strongest merger case scenarios for the creation of unilateral market power is a merger between two firms with a high combined market shares and "have products that are generally preferred by customers relative to the products of the fringe firms."[67]

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[61] PARKER & MAJUMDAR, *supra* note 45, at 475.
[62] NIELS ET AL., *supra* note 27, at 312.
[63] Starek and Stockhum, *supra* note 49, at 806.
[64] Thomas, *supra* note 43, at 392.
[65] PARKER & MAJUMDAR, *supra* note 45, at 476.
[66] MAJUMDAR, *supra* note 38.
[67] Starek and Stockhum, *supra* note 49, at 809.

The above notwithstanding, it would neither be appropriate nor correct to conclude that mergers between closest competitors dealing in differentiated goods always lead to unilateral effects and are therefore harmful to competition. This is especially true considering that in differentiated goods, the degree of substitutability amongst products is influenced largely by consumer preference. Consider the alternative situation in **Table 3** below:

Firm	Sales at current prices	Sales if A raises prices by 5%	Diversion ratio from A
E	100	80	-
F	100	109	45%
G	100	108	40%
H	100	103	15%

Table 3. Illustration of Diversion Ratios.

Here, F appears to be the closest competitor to E with a diversion ratio of 45%. However, G is not that far behind as it constitutes the second-closest constraint with a diversion ratio of 40%. Thus, in evaluating an EF merger, it is apt to consider that G is *almost as close* to E as F is to E, and therefore sufficient post-merger competition remains.[68] Post-merger, EF may be unable to profitably increase its prices since another nearly-as-close alternative, G, can act to limit the extent of such increase.[69]

On the other hand, it also cannot be concluded that mergers between parties who are not each other's closest competitors are not harmful to competition. A merger between E and G could very well result in a post-merger increase in prices. An EG merger removes the second-closest constraint on E, and thus may still be "close enough" to create cause for initial concern and further investigation, given the high diversion ratio between the merging parties.[70] Indeed, firms other than each merging firm's closest competitor may provide important, almost equally close, competitive constraints.[71]

Thus, there is no reason to limit the assessment of horizontal mergers in differentiated products markets to the determination of whether or not the merging parties are each other's closest competitors—all the competitive

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[68] PARKER & MAJUMDAR, *supra* note 45, at 477.
[69] BISHOP & WALKER, *supra* note 14.
[70] PARKER & MAJUMDAR, *supra* note 45, at 476.
[71] BISHOP & WALKER, *supra* note 14.

restraints on the merged firm should matter.[72] Thorough horizontal merger assessment requires the adoption of a comprehensive, holistic approach, considering both demand- and supply-side responses as competitive constraints. These constraints shall be discussed in further detail in Part IV below.

E. Closeness in Homogenous Goods Markets

We now consider whether or not closeness of competition is relevant in assessing unilateral effects arising from homogenous goods mergers. To recall, homogenous goods are those which consumers view as nearly identical. Firms producing homogenous goods traditionally compete on quantity and not price[73]—they first commit to their output and the "market" price becomes that which "clears" the market of this output.[74] The theory of harm, therefore, is that the merged firm reduces output compared to the total produced by the merging parties, pre-merger. A firm may leave capacity idle, refrain from building or obtaining capacity that would have been obtained absent the merger, or eliminate pre-existing production capabilities.[75] In response, rival firms may increase input a little but not by enough to offset the reduction in output by the merged firm. Overall output falls and price rises.[76]

It is suggested that closeness of competition is irrelevant in homogenous goods markets since all the firms' products are near perfect substitutes.[77] All firms producing identical goods must then be each other's closest competitors. Consequently, identifying closeness would not distinguish a pro-competitive merger from a harmful one. However, it is worth mentioning that identical products may still be to some extent differentiated, for example, by their locations or costs of production. If two firms producing homogenous goods are the only ones serving a particular customer base or having the lowest costs, they may be considered each other's closest competitors.[78] In the same vein, firms producing nearly identical goods may likewise be regarded as particularly close competitors if they have better

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[72] Dennis W. Carlton, *Revising the Horizontal Merger Guidelines*, 6 J. COMPETITION L. & ECON. 619, 628 (2010).

[73] This is referred to as the *Cournot* economic model.

[74] Starek and Stockhum, *supra* note 49, at 813.

[75] EINER ELHAUGE & DAMIEN GERADIN, GLOBAL COMPETITION LAW AND ECONOMICS 934 (2d ed. 2011).

[76] MAJUMDAR, *supra* note 38.

[77] BISHOP & WALKER, *supra* note 14.

[78] PARKER & MAJUMDAR, *supra* note 45, at 514.

capacities to increase their output than their non-merging rivals.[79] The intuition behind this is the greater a firm's ability to increase output, the stronger the competitive constraint that it exerts on another firm producing the same goods.[80] Thus, assessment of mergers between two firms which (i) serve the same customer base, (ii) have similar cost structures, or (iii) face similar capacity constraints may involve treating the fact of "closeness" between them in the same manner as in a differentiated goods merger.

Nonetheless, closeness of competition may be more informative of unilateral effects in the context of a price-setting bidding market involving homogenous goods. Economic theory suggests that where two identical firms participate in a bid and compete on price, market outcomes are likely to be competitive, even with just two players. In theory, where a sealed bid prevents rival firms from observing each other's bids, each firm would seek to undercut its competitor by pricing as close as possible to cost. Therefore it has been suggested that, so long as there are two firms post-merger, competition is not affected.[81] However, this would not be the case where a merger involves first- and second-place bidders, as the frequency at which one of the merging parties is the runner-up indicates that they are closest competitors. A merger of the winning bidder and the runner-up is likely to be harmful because the runner-up exerts a competitive constraint on the firm that ultimately wins the bid.[82] This is because in most tenders, it is the second-placed bidder that effectively determines the price—there is no incentive for the winning firm to set the absolute lowest price if its marginal cost levels permit the setting of a higher price to win.[83] Unilateral effects tend to be greater, the closer the gap of the runner-up is to the winning firm, and the more distant the remaining bidders are. Such effects are therefore less likely where there are many equally placed bidders.[84]

IV. OTHER FACTORS AFFECTING UNILATERAL EFFECTS ASSESSMENT

From the preceding sections, we have seen that closeness of competition is a core factor in horizontal merger analysis. In practice, particularly in the UK, the fate of most mergers is determined by factors relating to closeness of competition.[85] However, closeness of competition in

[79] Thomas, *supra* note 43, at 394.
[80] *Id.*
[81] PARKER & MAJUMDAR, *supra* note 45, at 519.
[82] *Id.* at 520.
[83] KOKKORIS & SHELANSKI, *supra* note 44, at 235.
[84] ELHAUGE & GERADIN, *supra* note 75, at 933.
[85] PARKER & MAJUMDAR, *supra* note 45, at 471.

and of itself is not the sole determinant of unilateral effects—it is likewise important to examine dynamic responses by rivals and customers as these may constitute key competitive restraints that could render a post-merger price rise unprofitable for the merged firm.

A. Entry and Repositioning

Supply-side responses to a merger such as entry and repositioning may work against an attempted post-merger price rise. These may be examined through a threefold approach based on timeliness, likelihood, and sufficiency of the activity.[86] Thus, even in a merger where the parties are each other's closest competitors, the elimination of one of them may not be harmful if rivals (whether existing or new) can enter the merged firm's product spectrum.[87] The PCC Merger Review Guidelines consider entry and/or expansion by existing competitors as an "integral part of the analysis of whether a merger is likely to harm competition significantly, and allow the merged firm to raise prices or reduce output, quality, or innovation."[88]

Under the PCC Merger Review Guidelines, entry and/or expansion, to be likely, must be profitable to the existing competitors of the merged entity or to new entrants.[89] In turn, profitability depends on (a) the output level the entrant is likely to obtain; (b) the price the entrant would likely obtain in the post-merger market; and (c) the cost per unit the entrant is likely to incur.[90] The PCC will likewise consider the history of entry and exit within the relevant market as well as barriers to entry.[91]

With respect to timeliness, the PCC Merger Review Guidelines merely consider whether entry and/or expansion would take place "within a reasonable period of time after the merger," which is usually within two years.[92] The two-year period is not inflexible, as the time period may vary according to the characteristics of the relevant market.[93] This is consistent with the approach of the UK, which typically considers two years as timely but with the caveat that the period shall be assessed on a case-by-case basis.[94]

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[86] ELHAUGE & GERADIN, *supra* note 75, at 933.
[87] NIELS ET AL., *supra* note 27, at 328.
[88] PCC Merger Review Guidelines, § 8.1.
[89] PCC Merger Review Guidelines, § 8.5.
[90] ELHAUGE & GERADIN, *supra* note 75, at 982.
[91] PCC Merger Review Guidelines, § 8.6.
[92] PCC Merger Review Guidelines, § 8.7.
[93] PCC Merger Review Guidelines, § 8.7.
[94] PARKER & MAJUMDAR, *supra* note 45, at 686.

Finally, the PCC determines entry and/or expansion to be sufficient, if it is large enough in scale to be able to compete with the merged entity.[95] Other jurisdictions also consider the degree of product differentiation—in the UK, small-scale entry for homogenous goods may be sufficient where there are no barriers to further expansion,[96] and in the US, even large-scale entry may be deemed to be insufficient where the products offered by entrants are not close enough substitutes to the products offered by the merged firm.[97]

B. Countervailing Buyer Power

Purchasers may also exercise buyer power to counteract unilateral effects by sponsoring the expansion of existing competitors or new entry.[98] In some circumstances, customers may have the incentive and ability to defeat the exercise of market power through their bargaining strength against the seller because of their size, commercial significance to the seller, or ability to switch to alternative sources of supply.[99] Very large buyers may have the ability to encourage or sponsor entry, or produce the product themselves, while retail customers are unlikely to have the scope to self-supply or sponsor entry.[100] Thus, where only some (*i.e.* larger) customers possess buyer power, the extent to which the buyer power of these customers may be relied upon to protect *all* customers must be assessed.[101] Nonetheless, what is important is that all applicable dynamic competitive constraints are taken into account in the analysis of horizontal mergers.[102]

C. Efficiencies and the Failing Firm Defense

Apart from demand- and supply-side responses, efficiencies arising from a horizontal merger must likewise be considered. Efficiencies can potentially outweigh the adverse effects of reduced competition.[103] The PCA provides that the PCC can exempt an otherwise anti-competitive merger from prohibition where the "concentration has brought about or is likely to bring about gains in efficiencies that are greater than the effects of any limitation on competition that result or likely to result from the merger or acquisition

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[95] PCC Merger Review Guidelines, § 8.8.
[96] PARKER & MAJUMDAR, *supra* note 45, at 688.
[97] ELHAUGE & GERADIN, *supra* note 75, at 983.
[98] BISHOP & WALKER, *supra* note 14.
[99] PCC Merger Review Guidelines, § 7.9.
[100] PARKER & MAJUMDAR, *supra* note 45, at 468.
[101] *Id.* at 695.
[102] *Id.* at 469.
[103] NIELS ET AL., *supra* note 27, at 349.

agreement."[104] The PCC Merger Review Guidelines enumerate the following as possible pro-competitive benefits of a merger: lower prices, improved quality, enhanced service, and new products.[105] As efficiencies are difficult to verify, the burden is on the merging firms to substantiate their efficiency claims[106] by presenting detailed and verifiable evidence of anticipated price reductions or other benefits.[107] Assessment of efficiencies involves a weighing exercise, where the anti-competitive effects of a merger must be balanced against the pro-competitive effects resulting from efficiencies to determine whether or not the net effect of the merger is a substantial lessening of competition.[108] The greater the potential adverse competitive effect of a merger, the greater must be the demonstrated efficiencies, and the more they must be passed through to customers.[109]

Merging firms may likewise invoke the "failing firm defense" to exempt an otherwise anti-competitive merger from prohibition. Under Section 21 (b) of the PCA, the parties must establish that either "party to the merger or acquisition agreement is faced with actual or imminent financial failure, and the agreement represents the least anti-competitive arrangement among the known alternative uses for the failing entity's assets." Transactions of this type may be exempt for prohibition because the competitive constraint exerted by the failing firm would be lost even without the merger (*i.e.* the failing firm and its assets would exit the market). In such a case, the post-merger scenario would be no different from the competitive situation that would have prevailed absent the merger.[110] It is not sufficient, however, that the failing firm would be unable to survive; it must be shown that the merger is the only, or least anti-competitive way, of maintaining its assets in the market.[111]

V. COORDINATED EFFECTS

The preceding discussion in this Article highlighted the relevance (or lack thereof) of evaluating closeness of competition in analyzing potential unilateral effects of horizontal mergers. It must be stressed, however, that in reviewing horizontal mergers, the likelihood that coordinated effects result

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[104] PCA, § 21(a).
[105] PCC Merger Review Guidelines, § 9.2.
[106] PCC Merger Review Guidelines, § 9.5.
[107] PCC Merger Review Guidelines, § 9.6.
[108] PARKER & MAJUMDAR, *supra* note 45, at 700.
[109] PCC Merger Review Guidelines, § 9.8.
[110] PCC Merger Review Guidelines, § 10.3.
[111] NIELS ET AL., *supra* note 27, at 306.

from such mergers should not be overlooked. Coordinated effects may arise when, as a result of the merger, existing collusion is made more harmful or collusion is substantially more likely to occur (where it is not already occurring).[112] Unlike unilateral effects, which considers only the post-merger actions of the merged firm, in coordinated effects analysis, the MAO looks at "whether the merger increases the likelihood that firms in the market will successfully coordinate their behavior or strengthen existing coordination in a manner that harms competition."[113]

A crucial starting point is whether the industry is one where tacit coordination is expected to be "easy." The MAO considers the homogeneity in the firm's products, since it is easier to coordinate on terms such as price when competing products are substantially the same.[114] Indeed, the more homogenous products are, the easier it is to agree on the collusive output.[115] In contrast, coordination is generally more difficult in markets with differentiated products, as there are more competitive dimensions than just price on which the colluding firms must agree.[116]

Since coordinated effects are most likely to arise from homogenous goods mergers, closeness of competition between the two merging firms is not likely to play a crucial role in the assessment since all firms producing identical goods are presumed to be equally close to each other. Closeness of competition would be more relevant in differentiated goods mergers, but as discussed above, a differentiated product market is unsuitable for successful coordination.[117] Not to mention, product homogeneity is only one of the factors considered by the MAO in determining whether market conditions are conducive to reaching to terms of coordination. Other factors are enumerated in Section 7.14 of the Merger Review Guidelines. In addition to these, the MAO also looks at the participants' ability to detect and respond to deviations from the terms of coordination[118]—firms must have the ability to punish deviations in a manner that will ensure that coordinating firms find it more profitable to adhere to the terms of coordination than to deviate, given the cost of reprisal.[119] Finally, the MAO considers external constraints and whether they can prevent the creation or enhancement of coordinated

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[112] PARKER & MAJUMDAR, *supra* note 45, at 589.
[113] PCC Merger Review Guidelines, § 7.10.
[114] PCC Merger Review Guideline, § 7.13.
[115] BISHOP & WALKER, *supra* note 14.
[116] NIELS ET AL., *supra* note 27, at 335.
[117] SIMON CHISHOLM, UNIT 10: COORDINATED EFFECTS 11 (2019).
[118] PCC Merger Review Guidelines, § 7.16.
[119] PCC Merger Review Guidelines, § 7.17.

interactions. The past behavior of firms, the presence of new, "maverick" firms, and countervailing buyer power are all taken into account.[120]

In summary, there are numerous factors that must be taken into account in analyzing coordinated effects, of which homogeneity of products (and thus, closeness of competition) is but one. Thus, while closeness of competition may serve as an important indicator that a particular market is susceptible to coordination, it merely speaks to the ease at which coordination may be achieved, but does not in and of itself establish the fact that such coordination is likely to place.

VI. CONCLUSION

With the passage of the PCA came the establishment of a compulsory notification regime for mergers and acquisitions. To guide businesses and the public, the PCC has issued rules and guidelines to ensure clarity and transparency in the merger review process. Nonetheless, where there are gaps in the law or regulation, foreign precedent may be turned to for guidance.

In the analysis of any horizontal merger, the PCC attempts to determine whether post-merger, the merged firm would be able to exercise market power resulting in higher prices. Harm may result principally from unilateral effects, or the ability and incentive of the merged firm to profitably increase its prices post-merger. Mergers might also give rise to coordinated effects, where post-merger, the merged firm together with its competitors can engage more easily in coordinated behavior. Closeness of competition, while helpful in assessing unilateral effects in differentiated goods mergers, is only one of several factors to be considered. Dynamic responses of rivals and buyers may also impose important competitive constraints. Moreover, statutory exemptions such as efficiencies and the failing firm defense must be taken into account. Closeness of competition plays an even less relevant role in analyzing coordinated effects, which are said to arise most likely from homogenous goods mergers. In such instances, closeness of competition merely provides insight into whether or not market conditions make it conducive to coordinate, and must concur with a multitude of other factors. While helpful, closeness of competition is not the be-all and end-all of horizontal merger assessment—ultimately, all competitive constraints must be taken into account in order to arrive at a comprehensive analysis.

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[120] PCC Merger Review Guidelines, § 7.19.